



AVIVA INVESTORS INVESTMENT RESEARCH: TIME FOR A BRAVE NEW WORLD?

Sustainable Income | Capital Growth | Beating Inflation | Meeting Liabilities

For today's investor





Capital markets are the engines that drive the global economy. They help put capital to work in businesses around the world; providing employment for billions and generating returns for investors.

But we think the markets could – and should – work better. Currently, incentives for investment are often misaligned, and investors do not always receive the information they need to make long-term decisions. That's one reason why we undertook this study of sell-side research.

Sell-side research has a significant influence on investors' decision-making. But our study shows this research is often flawed. Analysts want to write long-term, in-depth research but in many cases, do not feel incentivised to do so or to incorporate sustainability issues into their work. Because of business conflicts, many analysts feel unable to express negative views about the companies they monitor. The research they produce is too often positive, short term and incomplete.

This, in turn, contributes to a misallocation of capital. If capital is not efficiently and effectively allocated with long-term considerations in mind, our clients will not receive as much as they could from their investments – and may have a poorer retirement. It means we may all retire into a world that continues to pollute the environment and treat people unfairly.

This needs to change. We need sell-side culture to support good corporate culture so that positive sustainable long-term company performance is properly rewarded by the markets.

Fortunately, there are solutions to this problem, which we begin to explore in this paper. Policymakers, regulators and participants in the capital markets all have a role to play. Together, we can retune the engine of the economy and make the markets work for the benefit of everyone.

Euan Munro
Chief Executive Officer
Aviva Investors

tomorrow's
company **EXTEL**®

SUMMARY AND RECOMMENDATIONS

Capital markets¹ play an incredibly important role in society. Productive economies require profitable companies with sustainable long-term business models to provide jobs and wealth. Such companies need to be able to attract the support of the capital markets.

Sell-side analysts are a crucial part in how capital markets work, helping to inform capital market participants and their ultimate decision on where to invest by providing investment analysis and recommendations which shape their buy and sell decisions.

We commissioned this study [see box] to better understand why sell-side research tends to focus on the short term and does not integrate material non-financial issues. This is a concern to us because ignoring these considerations leads to capital being allocated on an inappropriately short-term basis, potentially rewarding poor corporate practices.

This ineffective allocation of capital is not in the interests of long-term shareholders, our clients, society or the economy. For capitalism to be sustainable, sustainable companies should be rewarded with a lower cost of capital.

¹ The Appendix provides an introduction to equity capital markets, previously published in Aviva White Paper: **A Roadmap for Sustainable Capital Markets**, 2015.

ABOUT THE STUDY

We commissioned an independent, online EXTEL survey of global equity sell-side analysts and a series of anonymised one-to-one interviews by Tomorrow's Company with analysts and heads of research. The data were analysed by independent experts Steve Kelly of Steve Kelly Research and previously at Extel, and Tomorrow's Company.

The survey sought to determine answers to the following questions from the perspective of a mainstream² sell-side analyst:

1. How influential is sell-side research?
2. How do you rate the quality of sell-side research?
3. What are the barriers and constraints to long-term, broad-based research?

The survey findings and study details are outlined in this paper.

We would like to extend our thanks to both Steve Kelly and Tomorrow's Company who brought their expertise and knowledge to the design, analysis and outcome of the study.

The study findings indicate that the current system does not encourage or reward sell-side analysts for producing long-term, broad-based research that also considers a company's Environmental, Social and Corporate Governance (ESG) performance. There are many reasons why this is the case and it is clear analysts have to meet competing requirements when producing research:

- Analysts perceive the buy-side (asset managers) is not asking for long-term research or coverage of broader themes.
- Many analysts would like to provide more in-depth research but are unable to do so because of commercial conflicts of interest and time spent on non-research activity.
- As well as these internal challenges, analysts can also receive external pressure from company management and investor relations on the content of research notes.
- Analysts do not routinely see companies and management telling the long-term story or building ESG performance into their overall strategy.
- This research demonstrates that it would be very difficult for an individual analyst or research team to overcome these pressures to focus on the short term and maintain a successful research franchise. Essentially, the sell-side is behaving rationally within an irrational system.

Our findings indicate that as many as 90 per cent of analysts would undertake some additional caution when writing on topics sensitive to their bank. Over a third of respondents readily acknowledge the need to avoid damaging investment banking relationships if they are to have a successful career. This has consequences for the efficient functioning of markets.

Significantly, 42 per cent of analysts agree that sell-side research has a detrimental short-term focus, and only 35 per cent agree sell-side research tackles controversial topics and offers negative assessments of companies where appropriate. We also find that a mere 12 per cent of mainstream sell-side analysts' time is spent researching companies' prospects beyond a 12-month horizon.

Culture and incentives within the investment chain need to change.

The sell-side is just one part of a long chain of participants in the investment process – but is a vitally important link. Research can be highly valued and influential in how the buy-side makes investment decisions, and, in turn, the way capital is allocated to companies. Sell-side culture needs to reward good corporate culture.

Policymakers, regulators and all market participants should seize the opportunity that MIFID2 implementation presents – which changes how asset managers pay for the research they use to make investment decisions to encourage and incentivise this

² A mainstream analyst produces research for mainstream investors ie. non ESG Environmental, Social and Governance investors.

³ **MIFID2:** EU legislation to improve the functioning of financial markets by increasing transparency and protection, shifting trading to structured market places, lower the cost of market data, make the costs of trading and investing clear and explicit. See Appendix to this paper and: www.fca.org.uk/markets/mifid-ii

change. In a post-MIFID2 world it needs to be rational and commercial for sell-side research to consider long-term, wider sustainability issues.

We believe the broad ecosystem within which analysts operate must continue to change if sell-side research is to reflect the longer term and material non financial matters. Our research confirms that more needs to be done to promote a long-term focus and a consideration of broader issues.

The research also supports the analysis in the recent EU High Level Expert Group on Sustainable Finance Interim Report⁴, which examines how long-term thinking can be encouraged throughout the financial system. The time is right for policymakers and all market participants to review incentives and motives along the whole investment chain.

We hope this paper will contribute to discussions on how various conflicts and challenges can be resolved. We have made some preliminary suggestions for change that span the investment chain – from companies through to asset managers - and policymakers:

RECOMMENDATIONS

Sell-side

- Heads of research should develop a culture that encourages analysts to include long-term non-financial issues within research notes and rewards them accordingly.
- Research teams and analysts should only be rewarded for producing high-value research, not for meeting demand for other activities such as sales.
- Analysts should be provided with in-house training on broader ESG topics. Heads of research should drive this.
- Heads of research should defend their analysts if and when companies call to criticise.
- A proportion of analysts' pay could be deferred for, say, two years and then paid subject to completeness and accuracy of the research.

Investment banks

- Analysts should have fewer companies to cover and less non-research related activities to free up time for more in-depth research.
- Investment banks should consider better separation of research from investment banking and trading and sales in order to reduce commercial conflicts of interest.

Asset managers

- Asset managers (buy-side) should direct a proportion of their research payments towards brokers conducting longer-term research that integrates sustainability issues.
- Asset managers should recommend to clients that a proportion of research payments are directed accordingly.
- Asset managers should avoid applying pressure on sell-side analysts to change their research outcomes to justify investment positions.
- Asset managers should ensure that ESG is mentioned in broker review comments.

Asset owners

- Asset owners (the clients of asset managers) should press their asset managers for a longer-term approach to managing their investments.
- Asset owners should ask for transparency over the type of research their asset managers buy.
- Asset owners should require their investment consultants to promote the integration of ESG matters in new manager searches.

Investment consultants

- Investment consultants should encourage and advise their asset owner clients to factor in long-term ESG capabilities when appointing asset managers.
- Investment consultants should provide evidence of when they have advised clients to take a longer-term view, including having regard for broader ESG issues.

⁴ Financing a Sustainable European Economy: Interim Report of the **High-Level Expert Group on Sustainable Finance**, July 2017.

Policymakers and Regulators

This section of the recommendations refers, in the main, to UK regulators but they are applicable to other national regulators too.

- The Department for Business, Energy & Industrial Strategy, (BEIS) in conjunction with UK regulators such as the FCA, should require all sell-side company research to include a section that looks beyond 12 months and to include a specific ESG performance analysis section.⁵
- The Financial Reporting Council should set up a whistleblowing line for analysts and heads of research wanting to highlight inappropriate corporate conduct
- The Financial Conduct Authority (FCA) should make it clear that long term ESG research should be encouraged under Research Payments and direct fund managers to proactively raise this issue with their clients.
- The (BEIS) Select Committee should conduct a review of the restrictive practices within sell-side firms that put pressure on analysts as to what they can and cannot write.
- The FCA should work with investors and the sell-side to investigate how they can promote better long-term research in a post-MIFID2 world.
- The FCA should look to better assess relationships and potential conflicts between the sell-side and companies in providing corporate access for the buy-side by monitoring corporate access awarded to research firms by companies, access afforded at investor conferences, conference calls and Q&A allocation. Regulators should monitor analyst research output and company behaviour in light of this information.
- The FCA should monitor advice given by investment consultants to their clients to ensure it includes long-term sustainability issues.

Chartered Financial Analyst (CFA) Institute⁶

- The CFA should require sustainability and ESG factors as an essential part of financial accreditation for analysts, so it becomes embedded into the research process, rather than an add-on or afterthought. (To that end, we strongly welcome the recent announcement that the CFA and UN PRI are to collaborate on a global study on how ESG issues are used by mainstream investors⁷).

Companies

- Companies should proactively articulate their integrated long-term strategy for value creation, including the risks and opportunities presented by broader, non-financial factors.
- Where companies incorporate long-term and broader issues they should try, as far as possible, to provide information that is measurable and linked to value creation.
- Companies should ensure fair access to sell-side analysts.
- Companies should welcome and learn from alternative points of view including negative perspectives offered by analysts.

Further studies

- We encourage further research on why mainstream analysts feel it is not important to factor in environmental factors in their research.
- We believe the demand for short- versus long-term research is an area for further research.
- Further research should be carried out on why the mainstream ranks climate change so lowly as a material issue.

⁵ This would help deliver research that would otherwise not be funded by the market and overcome the conflicted culture that currently exists for research provision. In turn, the research could be targeted at many of the areas the UK Government has identified as needing attention, for example: short term capital markets, poor productivity, inequality in society, lack of financial education amongst the public, and financing the Paris Climate Agreement.

⁶ The Chartered Financial Analyst (CFA) Program is a professional credential offered internationally by the American-based CFA Institute (formerly the Association for Investment Management and Research, or AIMR) to investment and financial professionals. A candidate who successfully completes the program and meets other professional requirements is awarded the "CFA charter" and becomes a "CFA charter holder".

⁷ Press Release: PRI teams with CFA Institute for global study on ESG investing, May 22 2017 [release].

INTRODUCTION

Capital markets play an incredibly important role in society. Economies rely on profitable companies with sustainable business models to provide jobs and create wealth for citizens. Allocating capital to deserving projects enables economies to continually improve their efficiency and allows them to meet society's current and future needs. In order to fulfil this role, companies need to be able to attract the support of the capital markets. But how do capital-market participants decide where to invest?

Sell-side analysts are a crucial part of how the capital markets work. Their research provides fund managers with investment analysis and recommendations, as well as useful data. This information has a significant influence on the buy, hold and sell decisions of investors – which may ultimately determine the success or failure of companies over the long term.

Too often, however, capital market participants allocate capital based on short term unsustainable reasons to maximise short term returns. This is a problem for the economy as a whole. If capital markets do not pay attention to long-term factors, capital may be misallocated.

In recent years there have been growing calls for capital market participants to adopt a longer-term focus and incorporate material sustainability considerations into their investment decisions. The Kay Review in 2011 focused strongly on the short term nature of UK capital markets and current government initiatives, such as Theresa May's Green Paper on Corporate Governance and The Treasury's Productivity Agenda, require markets to be much more long term if they are to achieve their objectives. The EU's High Level Expert Group on Sustainable Finance Interim Report⁸ is also very focused on encouraging this longer-term view.

Some investment banks have responded by employing small teams of Environmental, Social and Corporate Governance (ESG) analysts. While this is a welcome development, the majority of mainstream (ie. non ESG) sell-side research

papers continue to focus on a short-term outlook and ignore sustainability issues. Demand from the buy-side for material sustainability analysis is lower than it should be to sustain supply at the scale we consider necessary.

We have published this survey now as the market for sell-side research is going through significant change with The Markets in Financial Instruments Directive (MIFID2) and the final report of the Financial Conduct Authority's (FCA) Market Study into Asset Management⁹. Sell-side clients (the buy-side firms who consume the research) will no longer use commission sharing agreements to pay for research. This means that buy-side firms will pay for the research directly with its own funds or pay for such research from a designated research payment (RPA) account funded by specific charges on its clients.

In addition the FCA study will impose greater transparency requirements on how research is paid for. The expected outcome is that buy-side firms will limit the research they want to analysts who provide the greatest value. As a result, there will be less paid for research.

Sell-side analysts may wish to review how they work and what research they should produce to maintain a competitive position. There will always be some on the buy-side who will continue to want short-term research, but with the trend towards longer-term thinking and the requirement for transparency of trading costs, this may provide the opportunity for the buy-side to rethink what they need and for the sell-side to supply it.

Despite MIFID2 and the FCA's asset management study the sell-side will continue to be critical to the efficient functioning of capital markets. But there are challenges on the horizon.

The objective of this paper is to identify whether there are any cultural or operational barriers preventing sell-side analysts from producing longer-term research that pays due attention to the material impact of ESG factors, and to explore how such research might be encouraged in the future.

⁸ Financing a Sustainable European Economy: Interim Report of the High-Level Expert Group on Sustainable Finance, July 2017.

⁹ FCA Asset Management Market Study - Final Report, MS15/2.3, June 2017.

WHY IS THIS IMPORTANT?

There are several reasons why it is important for capital markets to have access to longer-term research that incorporates sustainability issues.

- Without robust, long-term investment analysis that integrates material sustainability issues, capital may be misallocated to high-risk projects that are not as resilient or sustainable as the market expects them to be. In addition, companies with good governance and sustainable cultures may not be duly rewarded with the lower cost of capital that would facilitate their growth. This has implications for long-term investment returns and the wider economy.
- The problems associated with short-term investment horizons are well known. Insufficient capital may be allocated to long-term projects. By prioritising short-term gain, the capital markets may jeopardise corporations and economies; witness the risks taken by banks that contributed to the global financial crisis of 2008-'09.
- Investment in socially-responsible funds is growing at a significant rate. More and more asset managers are integrating ESG into their investment decisions.¹⁰

ACADEMIC EVIDENCE

There is growing evidence that wider sustainability matters are material to a company's financial returns. Recently published academic evidence to support this is provided in Appendix 3. It is therefore important that ESG analysis is incorporated into investment analysis of companies.

ABOUT THE SURVEY

The research in this report is based on an online EXTEL survey completed by 342 sell-side research analysts across the world, supported by 18 face-to-face qualitative interviews with sell-side analysts, heads of research and investor relations officers. The survey was confidential and no individual analysts were identified in the data set provided or in this document. Face-to-face interviews by Tomorrow's Company were also carried out on a confidential basis and consisted of in-depth questioning on the topics covered by the survey questions.

This paper focuses mainly on mainstream sell-side analysts and not ESG analysts, although ESG analysts were also polled. Where the responses of mainstream and ESG analysts differ significantly, this has been drawn out in the findings.

It should be noted there was no significant difference in responses from analysts based in different geographical locations.

The survey aimed to determine answers to the following questions from the perspective of a mainstream analyst under the following headings:

- 1. How influential is sell-side research?**
- 2. How do you rate the quality of sell-side research?**
- 3. What are the barriers and constraints to long-term, broad-based research?**

The survey questions are provided in Appendix Two.



¹⁰ Global sustainable investment assets continuing to increase, global sustainable investment at the start of 2016 reached \$22.89 trillion, compared with \$18.28 trillion in 2014, an increase of 25 percent. The builds on the dramatic 61 percent growth between 2012 and 2014 which outpaced growth in total professionally-managed assets. Source: GSIR Review 2016, March 2017.

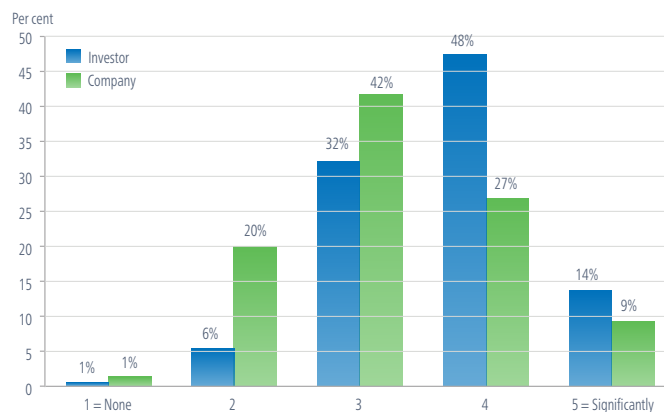
SURVEY RESULTS AND ANALYSIS

1. HOW INFLUENTIAL IS SELL-SIDE RESEARCH?

The purpose of asking the following questions is to determine the potential influence of sell-side research on the decision makers within companies and investment firms (buy-side) who use the research.

Respondents were asked to assess the extent to which sell-side research influences investor behaviour and company behaviour on a scale from 1 (none) to 5 (significant).

Questions: To what extent does sell-side research influence investor behaviour? And to what extent does sell-side research influence company behaviour?



Key findings:

- 94 per cent of sell-side analysts feel they have moderate to significant influence on investor behaviour (columns three, four and five) and 78 per cent feel they have moderate to significant influence on company behaviour (columns three, four and five).
- Only one per cent feel they have no influence on company and investor behaviour.

These responses are supported by evidence that suggests the buy-side pays a significant amount for research. Extel's estimate is that asset managers spend approximately \$2 billion on research providers in Europe. Globally, the industry budgets an annual \$16 billion for analyst research, according to BCA Research, an independent research house.

Interviews with investor relations officers provide further evidence that company management is influenced by sell-side analysis. The following comments show that management read and comment on the research written on their company:

"Company management really cares what the sell-side write, especially if it is incorrect or negative. They get an email every day with all the new sell-side research. They read it, then phone investor relations to complain if they disagree with something. Management probably read sell-side research more than the buy-side do." *Investor relations officer*

"Company management often asks investor relations to feed stories to certain analysts as a way to make something public. Quite a few ideas analysts write about are seeded by management and investor relations." *Investor relations officer*

While \$16 billion has been regularly quoted as the total annual budget for analyst research, studies indicate that much of the research supplied is not read, with only 2.5 per cent of research emails read each week¹¹. While good research is valued, there is a high volume - over 40,000 emailed each week by larger banks and brokerages¹² - and not all of it is valued. This will become much clearer as firms prepare for a post MIFID2 world, where the buy-side pay for research they want and the sell-side adapt their research models.

¹¹ Financial Times: Final call for the research analyst? 7 Feb 2017.

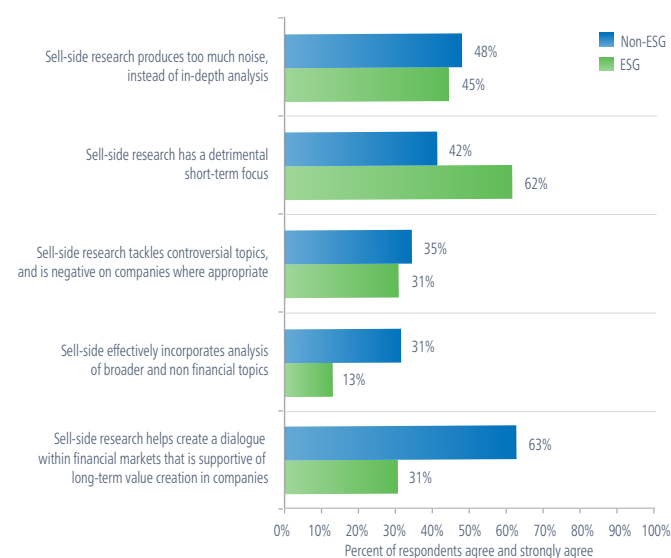
¹² Quinlan & Associates, August 2016. Research in an unbundled world - the outlook for sell-side research providers post MIFID2.

2. SELF-ASSESSING THE QUALITY OF SELL-SIDE RESEARCH

Having established the potentially significant influence of sell-side research on investor and company behaviour, it is imperative to assess whether this research is promoting – or hindering – the long-term interests of the economy.

In order to assess the quality of sell-side research we asked the following question:

Question: Do you agree with the following statements on the quality of sell-side research?



Key findings:

- A significant proportion (48 per cent) of mainstream sell-side analysts believe their industry produces too much ‘noise’ rather than in-depth research.
- 42 per cent agree sell-side research has a detrimental short-term focus.
- Only 35 per cent agree sell-side research tackles controversial topics and offers negative assessments of companies where appropriate.
- Only 31 per cent believe their research effectively incorporates analysis of broader financial and non-financial topics.
- 63 per cent of mainstream analysts believe their research creates a dialogue that supports long-term value creation in companies. Only 31 per cent of ESG analysts believe this.

It is not surprising that mainstream analysts have a more positive picture of sell-side research than ESG analysts; but it is clear both mainstream and ESG analysts recognise the shortcomings.

The responses from ESG analysts show some important differences. Up to 62 per cent of ESG analysts believe sell-side research is short term. This is far higher than mainstream sell-side analysts at 42 per cent, still a significant number. This is likely to be because their horizons are more long term to capture the material non-financial matters that may crystallise over a number of years rather than months.

While 63 per cent of mainstream analysts believe their research creates a dialogue that supports long-term value creation in companies, only 31 per cent of ESG analysts agree.

If research is short term (42 per cent of mainstream analysts think this) and does not tackle controversial topics (35 per cent believe this) and does not cover wider non-financial topics (only 31 per cent say they do) the research is likely not to accurately reflect the longer-term risks and opportunities.

3. BARRIERS AND CONSTRAINTS TO PRODUCING LONG-TERM RESEARCH THAT INCORPORATES MATERIAL NON-FINANCIAL MATTERS

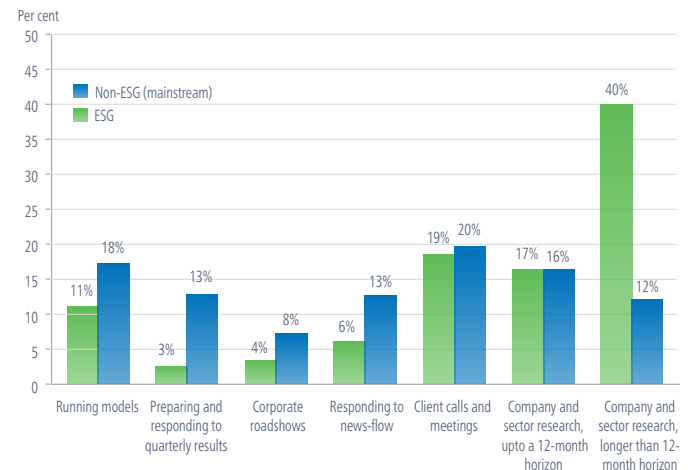
The findings above suggest a large proportion of mainstream research may not be conducive to long-term value creation or the integration of broader issues into investment analysis.

In order to determine why, we asked sell-side analysts a series of questions. From the responses, we identified the following as the main barriers to long-term, in-depth and broad-based research:

1 Not enough time

The purpose of the following question is to identify how the analysts' time is spent and if this impacts on the quality of research they produce. With this information it may be possible to re-assess workloads and create a better environment for writing research.

Question: What is your current time allocation between the following activities?



Key findings:

- On average, only 12 per cent of mainstream sell-side analysts' time is spent researching companies' prospects beyond a 12-month horizon. By contrast, ESG analysts spend 40 per cent of their time on research beyond 12 months.
- Only 28 per cent of mainstream analysts' time is spent on writing research. On average, most of analysts' time (72 per cent) is devoted to client marketing, corporate road shows, responding to news flow and maintenance activity (running models and reporting on quarterly results).

At the very least, we consider 'long term' as the investment cycle of the business in question. For many companies, such as pharmaceutical companies and oil and gas companies, the success or failure of their strategies are likely to manifest themselves over many years, often decades. Therefore, for many companies, looking out 12 months or even 24 months will not be sufficient to encompass all relevant information for investment decision-making.

One of the reasons for the prevalence of short-term research is likely to be the time spent on non-research activities.

Writing in-depth and long-term research takes significant time; often far more than commenting on quarterly trends or conducting financial analysis. The survey

suggests analysts have limited time for research and even less to spend on longer-term research.

This is because analysts face a number of demands on their time. It is important to note that the other activities – such as running models, collating quarterly results and responding to news flow – are an important part of the research process. We do not wish to argue that analysts should not carry out these other activities. Rather, we believe the time taken on these activities leaves little time for longer-term research. A solution may be for analysts to cover fewer companies.

However, in the current market environment this is unlikely to happen. Interview comments highlight that lack of time has become an increasing problem. As MIFID2 gets closer to implementation, and unbundling research from execution fees becomes a reality, resources for sell-side research are likely to be even more constrained and teams are likely to be cut in size. Asset managers have already cut their external research budgets and are bringing research in-house.

According to Quinlan & Associates¹³, 30 per cent of global asset managers plan to further slash their research budgets by a third. Time constraints are likely to become more acute.

“I think everyone strives to produce longer-term research that adds value but time pressure can limit the ability to do this effectively.”

Sell-side analyst

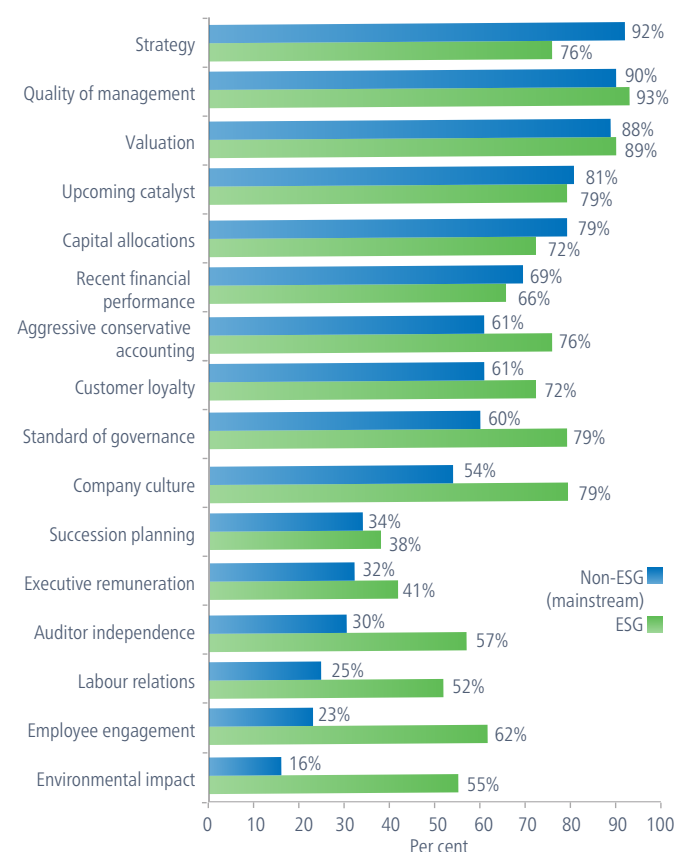
It is clear longer-term research cannot be delivered unless analysts' workloads are significantly eased. It seems particularly important for analysts to spend less time on non-research activities and reduce the number of companies they cover to a more manageable level.

2 ESG factors are not considered sufficiently important to the investment case

The next question aims to explore whether there are preconceptions among sell-side analysts that hinder the quality of their research.

For example: Do sell-side analysts fail to report on broader issues because they do not consider them important? Analysts were asked to rank the importance of various issues from 1 (not important) to 5 (very important).

Question: How important are the following factors in constructing an investment case?



¹³ Quinlan & Associates, August 2016. Research in an unbundled world - the outlook for sell-side research providers post MIFID2.

Key findings:

- There is general agreement between ESG and mainstream analysts on the traditional aspects of an investment case, including quality of management, valuation, upcoming catalysts, capital allocation and recent financial performance.
- The views and beliefs of ESG analysts differ significantly from mainstream analysts on the broader issues. The biggest difference is found in the areas of auditor independence, labour relations, employee engagement and environmental impact.
- The low importance mainstream analysts attach to environmental impact is particularly surprising given the growing acknowledgement across the financial world of the risk of increased regulation and stranded carbon assets. Mainstream sell-side analysts (16 per cent) consider environmental issues as the least important in constructing an investment case.
- Both groups place a relatively low importance on succession planning and executive pay, but attach significant importance to the quality of management, despite the fact these three areas are closely connected.
- The relative importance accorded to culture, coupled with the low importance of employee engagement, labour relations and environmental issues in the eyes of mainstream analysts – issues that are in fact indicative of a company's culture – suggests there are different definitions amongst analysts as to what the term means.

The most striking message from these results is that mainstream analysts do not consider some of the broader factors important. It is therefore unsurprising these factors are not often covered in mainstream research. This point is further emphasized by comments provided in the online and face-to-face interviews:

“The reason people don't look at culture is it does not matter to the share price. ESG exists in a silo, it is a sub-culture and very unrelated. For example, one company I cover has a specialist ESG investor relations officer who knows about all the ESG issues. Mainstream investors never ask about these so why would sell-side analysts? Even when a company in our sector had a significant governance problem with accusations of bribery and corruption, investors were only interested in what the size of the fine would be and hence the impact on cash flow.”

Sell-side analyst

This view is particularly worrying as deficient cultures have led to significant loss in value for some companies. Many see the banking crisis as being caused by a reckless culture that had no consideration for customers. Investors in Wells Fargo are now likely to see the close correlation between financial performance and culture. A recent article in the Financial Times, *'The Volkswagen scandal shows that corporate culture matters'* suggested VW's culture was such that illegal and arguably immoral behaviour became acceptable.

The perceived irrelevance of ESG factors may be another major reason why mainstream analysts do not cover them. Yet a growing number of academic studies demonstrate they are material,¹⁴ pointing to a positive connection between a company's responsiveness to ESG themes and its performance. For example, studies¹⁵ indicate that companies that treat their employees well are more productive and sustainable over the longer term.

¹⁴ See Appendix Three – Evidence of materiality of ESG factors.

¹⁵ 1. 'Family Firms, Employee Satisfaction, and Corporate Performance', University of Kansas; 2. 'Does the stock market fully value intangibles? Employee satisfaction and equity prices,' Alex Edmans Wharton School, University of Pennsylvania, 2011; 3. 'Does Company Culture Pay Off? Analyzing Stock Performance of "Best Places to Work" Companies,' Dr. Andrew Chamberlain, March 11, 2015.

But, as one analyst put it:

“Not sure I want engaged and happy employees, as a shareholder I want them to be underpaid.” *Sell-side analyst*

It is obvious good practice in this area is not always being recognised by the market. Companies with exploitative cultures – such as those that focus on cost-cutting at the expense of employees’ health and safety, or those that have excessively aggressive sales targets – may deliver better short-term profits than more ethical firms, but they are much more likely to fall victim to fines, consumer boycotts, strikes or other conduct issues over the longer term.

The results show mainstream sell-side analysts’ beliefs differ significantly from those of ESG analysts on drivers of future performance, with ESG analysts placing much more importance on sustainability and governance issues. This is not surprising. ESG analysts have dedicated their career to ESG research and have a professional interest that is likely to influence their responses. However, there is growing evidence sustainability issues matter materially both in the short term and the long term.

There are also a number of apparent inconsistencies in the results:

- Mainstream analysts believe strategy is the most important factor in an investment case; yet only 12 per cent of their time is devoted to analysing how a company performs beyond 12-months horizon. Most company strategies go well beyond a single year.
- Succession planning is ranked low, despite the fact corporate succession is often a price-moving event and is the mechanism for choosing excellent management, which analysts consider to be very important.¹⁶

- Equally surprising is that the environment is ranked least important among the issues considered by mainstream analysts, despite the risks and opportunities climate change will present to companies. Unsurprisingly, the situation is different for ESG analysts, for whom climate change ranks highly as a material future issue. We are not clear as to the reasons why the mainstream has ranked climate change so low. Further research is needed on this topic.

It is clear mainstream sell-side analysts do not tend to consider broader ESG factors when making their investment case.

Some analysts may be unaware of the raft of evidence on the impact of ESG factors on companies’ future performance and, as a result, do not see these factors as material.

For this to change, business schools and financial qualifications may need to give more weight to non-financial factors in investment analysis. The Chartered Financial Analyst Program (CFA) now includes more coverage of corporate governance and ESG considerations, which is a step in the right direction.¹⁷

We welcome the recent announcement that the CFA and UN PRI are to collaborate on a global study on how ESG issues are used by mainstream investors¹⁸.

¹⁶ A recent example was the change of Adidas’s CEO in 2016. The share price soared when the Henkel AG Chief Executive Karsten Rorsted was appointed to the Adidas board as a future CEO. The stock rose by over 11 per cent on the news. When the CEO of TalkTalk Dido Harding announced she was standing down in February 2017 the company’s share price rose by seven per cent. There are several recent academic papers that indicate management change affects share prices. See for example: 1. ‘How management risk affects corporate debt’, University of Utah, University of Minnesota, March 2016; 2. ‘Real Earnings Management around CEO turnovers’, University of Auckland, January 2016; 3. ‘Can management turnover restore the financial statement credibility of restating firms? Further evidence’, University of Toledo, National Cheng Kung University, National Taiwan University, Journal of Business Finance and Accounting, Oct 2014.

¹⁷ The Chartered Financial Analyst (CFA) Program is a professional credential offered internationally by the American-based CFA Institute (formerly the Association for Investment Management and Research, or AIMR) to investment and financial professionals. A candidate who successfully completes the program and meets other professional requirements is awarded the “CFA charter” and becomes a “CFA charter holder”.

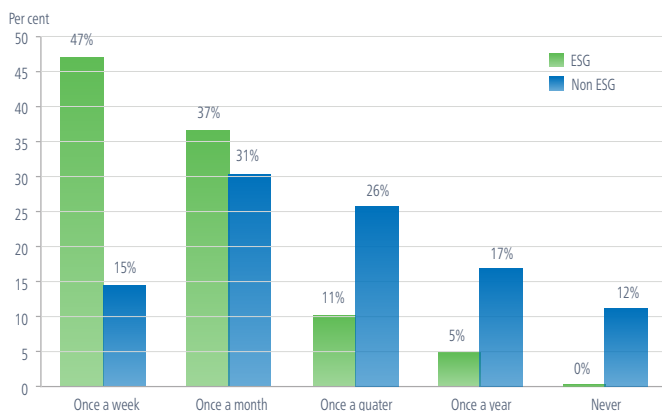
In their revised program for 2017 the CFA Institute says: “Over the last few years, risk factors related to a firm’s social and environmental pro-file—the Volkswagen emissions scandal serves as a prime example—have become economically material. As a result, a core skill required of investment advisers is the ability to integrate ESG factors into the portfolio construction process. The new Level I reading represents a significant advance in the coverage of ESG factors in the CFA Program.”

¹⁸ Press Release: PRI teams with CFA Institute for global study on ESG investing, May 22 2017.

3. There is insufficient demand from the buy-side

The purpose of this question is to assess whether there is currently any demand from the buy-side for information on companies' longer-term prospects or their approach to ESG issues. If demand for such information is low, it is unsurprising it is not often included in sell-side research.

Question: How often are you asked a question from the buy-side on broader and longer-term factors, such as governance, culture, and environmental and social impact?



Key findings:

- 12 per cent of mainstream, non-ESG analysts are never asked about broader, longer-term factors.
- 15 per cent are asked once a week.
- 74 per cent are asked, but less frequently.

Given the numerous meetings sell-side analysts have with their clients, these are very low numbers. The results are surprisingly consistent by geography and institution type.

It seems clear the buy-side is not asking for long-term, broad-based research.

"I seek to be longer-term in my focus where possible. I would love to do more thorough detailed strategic value-added industry research but I find that the markets are obsessed with implications of news flow (often noise) on the next quarterly numbers or what the short-term outlook is for the numbers – or maybe investors only value sell-side analysts for those judgements."

Sell-side analyst

"Rarely, sometimes on culture, most buy-side investor horizons are three-six months. Even at funds that are meant to take a long-term approach, they often still focus on the short term. Very few investors are genuinely long term."

Sell-side analyst

"I have only been asked an ESG question once in my career and that was from an ESG buy-side analyst."

Sell-side analyst

“Too much noise, ironically required/ requested by buy-side... NB not every investor has a long-term view or value bias. Alarming, the traditional long-term pension funds who should have a view of years are equally, if not more so, caught up in day-to-day noise. Elsewhere, I am stunned at the ‘herd’ obsession/mentality of funds – it seems many are more worried about being different than having a view. Furthermore, many buy-side firms have lost sight of doing their own thinking.”
Sell-side analyst

The problem is accentuated by the fact hedge funds are the biggest providers of research funding. Hedge funds trade frequently and typically want investment ideas over a brief time horizon. This creates pressure for analysts to focus on the short term.

“Hedge funds don’t care about the long term and they pay the most for research”
Sell-side analyst

The responses indicate the buy-side is not perceived to show sufficient interest to justify long-term, broad-based ESG research.

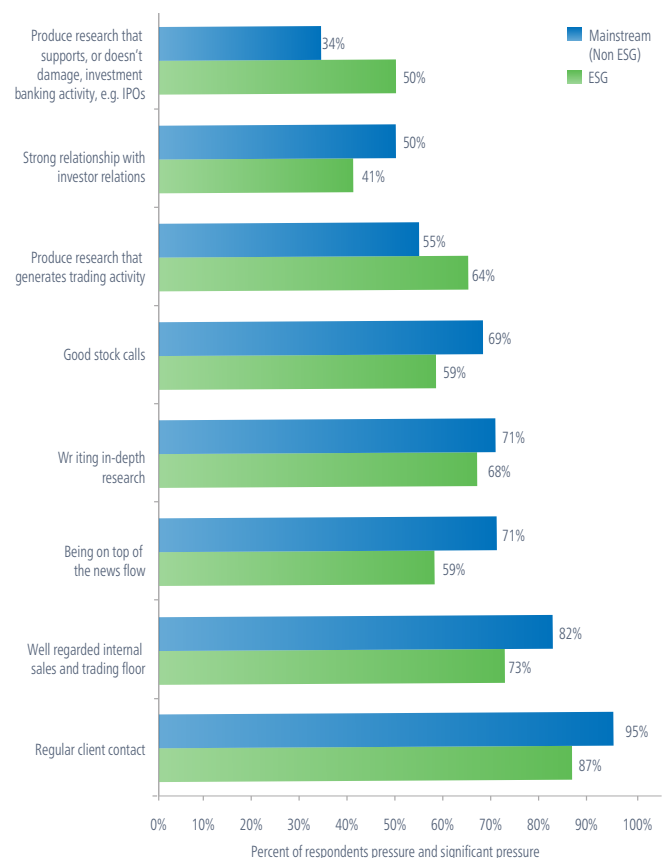
We believe further research should be carried out on the demand for short-term versus long term analysis. Many pension funds and buy-side asset managers say they are long term, but are they? It would be useful to identify the number of long-term asset managers in the UK relative to the number of short-term investors such as hedge funds that currently pay most for research. It is possible the MIFID2 regime will help in this regard.

4. Long term in-depth research is not aligned with career enhancement

The following question aims to identify whether writing longer-term, broad-based research is conducive for analysts’ career progression. Analysts need to know they will be rewarded for writing long-term research if they are to undertake it.

Respondents were asked to rate factors from 1 (not important) to 5 (very important). The chart below shows the percentage of respondents who attached a rating of 4 or 5 to each of these factors.

Question: How important are the following factors in having a successful career as a sell-side analyst?



Key findings:

- 95 per cent of mainstream analysts believe regular client contact is the most important factor for the success of their career.
- Contact with the sales and trading floor was the second most important factor, at 82 per cent. This is not surprising, as it is the route via which sell-side analysts can reach buy-side clients.
- 71 per cent consider being well-regarded by the sales and trading floor as important or very important.
- 55 per cent consider it important to produce research that generates trading activity.
- A significant minority (34 per cent) of mainstream analysts think it is important to produce research that supports – and does not interfere with – investment banking activities, such as IPOs (initial public offerings).

The importance of being well-regarded by the sales and trading floor is understandable but particularly worrying because this potentially creates significant conflicts of interest. The research should be independent, but the success or failure of sell-side analysts rests largely on how they are viewed by the sales and trading floor, and these views are based on how well their own commercial needs are met.

“Sales is a significant barrier, they are not interested in anything that is hard to understand. Research has to be significantly dumbed down for sales, for example, condensing a report into two minutes on a morning call. You have to spoon feed them but they are very important to your career.”

Sell-side analyst

“The key to a successful career as a sell-side analyst is building a big client franchise. To do this, you need to talk to lots of clients, and make them like you. It’s not really about the quality of research or making good stock calls.”

Sell-side analyst



Therefore, analysts have to find ever more ingenious ways of spinning the same story and taking advantage of new information, however modest. All of this facilitates short-termism and detracts from longer-term research.

Many analysts say they would like to carry out more in-depth research and yet it seems their career prospects will suffer if they do this. Instead, their priority is to report on ‘noise’, thereby keeping sales and trading desks happy.

The interviews provided further evidence of this, suggesting success comes from actively marketing to clients rather than writing high-quality in-depth research. Many analysts talked about a bias towards sales over substance and pressure from sales departments. Analysts often complained that sales added to the pressure to focus on the short-term; this may be because sales serve the highest-paying clients, which are predominantly hedge funds.

Other comments referred to the pressure to help generate trading commissions. This chimes with the survey results, which show 55 per cent of analysts consider it important to produce research that generates trading activity. Currently, the majority of research is paid for via trading commissions. Some teams even have a target level of commission, while some banks distribute daily data on the commission level in each stock. As such, there is a close relationship between the research team and the trader. If the trading commissions for the securities an analyst covers increase this can be beneficial to his or her career.

“You make a lot more trading revenue when you are actively writing research on a stock. This is partly because it creates trading ideas and partly because you need to get the trader comfortable in taking a position. When on the sell-side, a tiering system was introduced that stopped you writing long notes on low commission-generating stocks.”
Investor relations officer, former sell-side analyst

“Analysts should be paid for the quality of research and not be dependent on trading activity and revenues.”
Sell-side analyst

On top of this, as many as 34 per cent of mainstream respondents readily acknowledge they should avoid damaging investment banking relationships if they are to have a successful career. These conflicts are well known, and derive from the function of investment banks that intermediate between issuers and investors in capital markets. The information produced by an analyst in the research department can be of use to the bank’s investment bankers. To disparage a client or potential client of the investment bank would not, therefore, be beneficial for the bank or analyst’s career.

Reluctance to damage investment banking activity is likely to be a major reason why the majority of sell-side recommendations are generally positive.¹⁹

“A sell recommendation will receive far more scrutiny in an investment committee. I once had a tough investment committee on a sell where the head of research clearly knew a significant amount about the company. This can only have been because they had conversations with the bankers about it. If your work is good for the bankers you will get a good bonus.”
Sell-side analyst

These findings highlight the extraordinary conflicts that still exist in an analyst’s workplace. If these are important to a successful career, it is no wonder that writing in-depth research is the least of their priorities.

Our concern is that short-term research, aimed at promoting trading or investment banking activity, gives a skewed and incomplete impression of companies. This encourages capital markets to be more short-term and may lead to a misallocation of capital, either because capital is erroneously allocated to

¹⁹ Bespoke Investment Group’s 2015 study found that of the 12,122 ratings of The broad market Index (US) just 6.67% carried a ‘sell’ label.

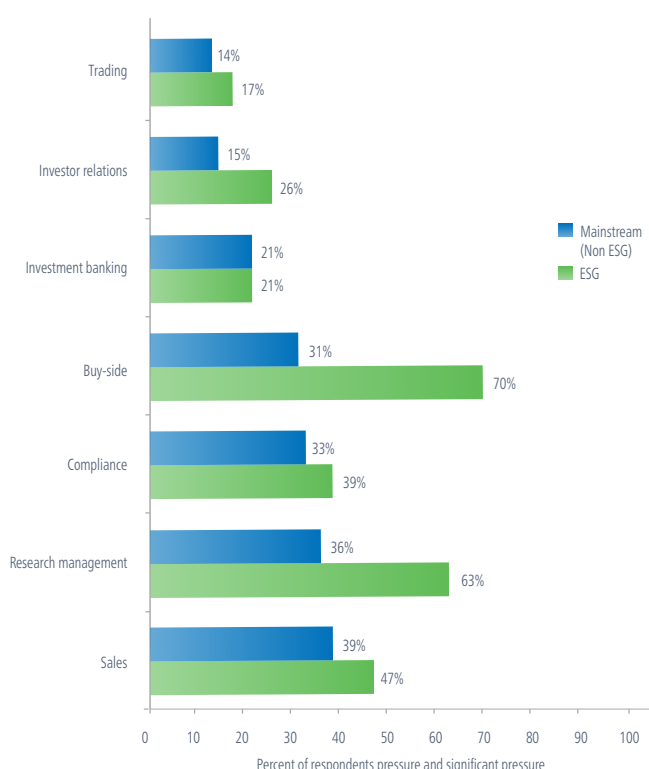
undeserving companies or because trading volumes increase as buy-side asset managers are persuaded to trade unnecessarily, with the resulting turnover leading to shorter-term holdings.

Sell-side analysts continue to have great influence on the allocation of capital. But the pressures and conflicts they are under are leading them to produce research that looks to enhance the profitability of investment banks at the expense of an efficient and properly functioning capital market. Policymakers should look carefully at these conflicts if they want capital markets to focus on the long term.

5. Significant pressure from within sell-side firms, companies, buy-side clients

The following question aims to identify the areas in which analysts might feel pressure that influences or constrains the research they write. Respondents were asked to rate the pressures they face in each area from 1 (no pressure) to 5 (significant pressure).

Question: What degree of pressure do you feel from the following groups that influences or constrains the research that you write?



Key findings:

- It is clear mainstream and ESG sell-side analysts come under pressure from a number of sources.
- For mainstream analysts, the most significant pressure comes from sales, research management and compliance. ESG analysts come under significant pressure from research management (63 per cent).
- Significant pressure also comes from buy-side clients (31 per cent). This is even more evident in the case of ESG analysts (70 per cent).

Pressure from sales, internal research management and compliance is an important finding as these are the areas that control the output of the research.

“While on the sell-side, writing on governance was a sensitive topic. At times I was told what not to write about. For example, writing about remuneration or the time commitment of NEDs was prevented.”
Former sell-side governance analyst, now on buy-side

This quote is significant as it suggests that analysts are prevented from writing complete research notes by internal departments. If research is published to keep the internal departments, rather than the client, happy, the quality of research may be compromised.

While this respondent did not say who instructed the analyst not to write about remuneration or time commitment of NEDs, comments we received from other respondents indicate that such constraints can come from compliance, legal departments and sales. It should be noted that compliance has been significantly strengthened on the sell-side to protect analysts from internal pressures and ensure good governance and risk practices. Legal constraints can inform compliance recommendations and this could be translated as caution by analysts.

“Compliance is a burden, restricting discussion of crucial changes e.g. politics impact.” *Sell-side analyst*

Our findings indicate internal departments put pressure on analysts if they produce negative reports on a company or if they cover controversial angles. Such reports often receive far more scrutiny from research management and compliance than positive reports. The interviews highlighted a strong sense from analysts that the risks far outweighed the possible rewards for publishing controversial sell recommendations. While the pressure is not as explicit as it might once have been, it is clear analysts feel implicit pressure.

“It is common for people to say they have a ‘broking buy,’ so yes, there are definitely still conflicts. I saw research management encouraging analysts to have a positive recommendation to help the banking business. People are aware who pays the bills; Chinese walls don’t work.”

Investor relations officer, former sell-side analyst

Although pressure from investment banking did not figure among the most acute sources of pressure identified by analysts in the survey, the interviews told a different story. The responses indicated that Chinese walls introduced following the 2003 Global Analyst Research Settlement²⁰ have broadly stopped explicit pressure, but implied pressure remains. Investment banking in general still pays for one third of the research budget, and as such there is a significant bias towards positive recommendations. The responses suggest quiet pressure is still applied through legal, compliance and research management. Promotion and bonus prospects were also mentioned in the interviews.

²⁰ The Global Analyst Research Settlement was an enforcement agreement reached in the United States on April 28, 2003, between the United States Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (NASD), New York Stock Exchange (NYSE), and ten of the United States’ largest investment firms to address issues of conflict of interest within their businesses in relation to recommendations made by financial analyst departments of those firms.

²¹ A Macquarie analyst was thrown out of PAX Global Technology meeting. He was the only one of twelve analysts with a sell rating. FT, August 2016

“Investment banking conflicts are still there. I’ve seen bankers phone the head of research on issues. One colleague had a sell recommendation blocked by legal but it was blatant why this had been done. They cited legal issues they couldn’t disclose but it was clear why it had been blocked.”

Sell-side analyst

The interviews also drew attention to pressure from investor relations (IR). In many cases, analysts said the conflict with investment banking had been surpassed by the need to be on good terms with IR.²¹

Having a good relationship with IR is critical for a number of reasons. Firstly, securing corporate access is important for a research analyst. Each quarter, IR decides which research analysts it will ask to organise roadshows for management.

Buy-side clients place significant value on being offered meetings with management. In addition, organising a roadshow is the only time a sell-side research analyst will have one-on-one time with senior management in a company. Being involved, therefore, helps an analyst build credibility on a stock.

Secondly, analysts rely heavily on calls with IR to clarify points of information when news flow breaks or on results mornings.

A close relationship with IR often means an analyst is first in line for a call. If results are announced at 7am, for example, a call with IR at 7.20am is considerably more valuable than a call at 8am, when the markets open.

In order to reduce these conflicts, consideration should be given to how information is disseminated so that all analysts are treated equally.

One key point that surfaced in the interviews is the way in which this conflict is transmitted through to analysts at investment banks. The head of research needs to keep the head of sales and equity capital markets (ECM) happy, and knows what sort of research would support the investment banking activity. This may be made clear to analysts through conversations with heads of teams or through greater scrutiny of calls that run counter to this objective.

“I was never told what to write, but you know who pays the money. But the pressure has got less over the last 20 years. There was a time when bankers would call you up but this doesn’t happen anymore. The pressure is now applied through senior management and you never know what conversations are taking place behind the scenes. The head of research needs to keep the head of sales and head of ECM happy. If research is preventing ECM activity then the head of research may not last that long.” *Sell-side analyst*

The interviews also revealed that implied pressure can be transmitted in a number of other ways; for example through decisions on promotions and bonuses, or through the level of scrutiny analysts receive from research management, the investment committee and compliance. These factors in aggregate lead to a strong implied pressure on analysts to desist from antagonising companies and to produce positive recommendations.

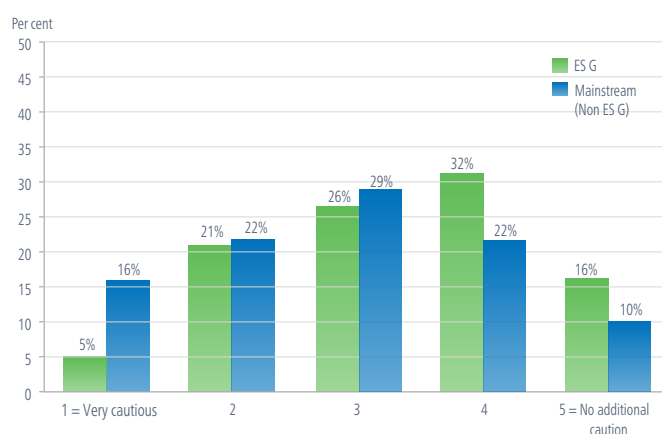
Finally, from the responses to this question, it appears buy-side asset managers also impose significant pressure on analysts to produce reports that back up their investment theses. They appear to impose more pressure than companies.

“Buy-side clients should not be hostile to research that contradicts or warns against their own positions. They should welcome the dialogue. In my experience, some buy-side clients are the most hostile to negative stock calls; surprisingly, even more than companies.”
Buy-side analyst

Confirmation bias is a well-known psychological phenomenon. The buy-side should welcome or even seek alternative points of view that may not align with their investment theses in order to make more considered investment decisions.

In order to test the true significance of internal conflicts within sell-side firms we asked the following question:

Question: If you were considering writing research that was sensitive to the bank or would damage the bank’s interest elsewhere, such as a sell rating, how much additional caution would you undertake?



Key findings:

- 90 per cent of mainstream analysts would undertake some additional caution when writing on topics sensitive to the bank.
- 38 per cent would exercise significant caution.

These findings indicate analysts are extremely wary of covering anything that could be perceived as negative or harmful to the bank and highlights, that conflicts continue between analysts and other departments, which affects the research outputs.

A key theme that emerged from the interviews was that, while analysts are not told what to write by any one set of individuals, a confluence of pressures from different sources leads to a culture of caution:

“Good sell ideas are not worth risking your job over!”

Sell-side analyst

“You have to get the facts right when you have a sell. You have nothing to gain from having a sell, you lose access to the company, and annoy investors. There are too many incentives not to be independent.”

Sell-side analyst

“If you write something negative on a company it has to be right. IR look at sell notes in detail and will highlight errors. Sometimes they may complain to the investment banking team.”

Current buy-side analyst, former sell-side

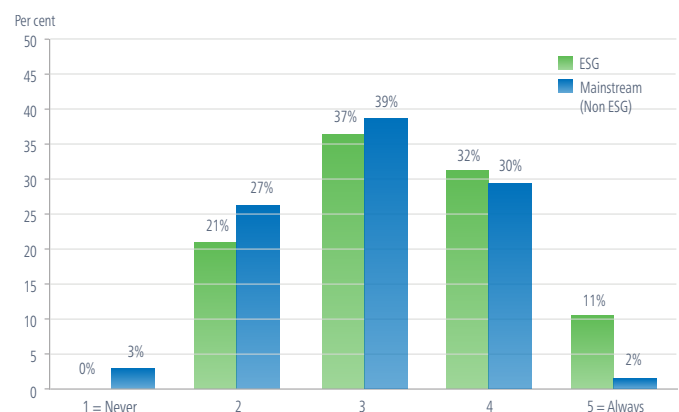
Wariness about writing reports that upset internal departments, companies or shareholders will naturally constrain what analysts are able to express.

6. Companies do not tell long-term stories

So far, we have mostly focused on sell-side analysts and the culture in which they work. In the following questions we broaden our scope to determine whether companies and/or the buy-side might also present barriers to longer-term, broad-based ESG research.

The next survey questions concern sell-side analysts' views on the extent to which companies and asset managers place emphasis on broad-based, longer-term factors. We ask whether companies integrate long-term factors into their strategy around value creation and also how often they are queried on these issues by the buy-side.

Question: How often do companies integrate the broader and longer-term factors into their story of value creation and disclosure?

**Key findings:**

- There is an even distribution of opinions on how often companies integrate ESG factors into their story of value creation.
- Almost one third (30 per cent) of respondents feel companies never or hardly ever seek to do this.
- 32 per cent responded that companies always or nearly always did integrate such factors.

While it is positive to see that many companies tell a longer-term story that encompasses broader issues such as environmental, social and governance issues, a significant number have more to do. If companies wish to have longer-term, patient investors on their registers, they will need to attach greater priority to broader, longer-term issues in their story of value creation.

It is possible companies' lack of focus on such factors has led sell-side analysts to view ESG as irrelevant to the investment story (see answers to question five).

Despite this view, recent high-profile incidents involving Volkswagen and the Bento Rodrigues dam disaster involving BHP Billiton and Vale highlight the growing importance of understanding companies' approach on ESG, health and safety, culture or sustainability issues. It is important these topics are disclosed to stakeholders, especially investors.

If companies do not talk about their long-term objectives or material ESG factors, the market may do it for them. For example, in 2017 several public benchmarking initiatives are being launched. These indices and benchmarks rank companies' performance on a number of ESG factors, from how companies are transitioning to a low carbon economy to human rights. Other initiatives that promote the Sustainable Development Goals²² at UK companies are underway. Markets and wider society will be able to use this information to get a sense of how well companies are dealing with sustainability issues. In a world of instant communication, poor performance in these areas could quickly impact companies' reputations and their businesses. Analysts are already using Glassdoor²³ to source information and write on employee morale in their research coverage.

Even when companies incorporate this information into their strategies, analysts can find it hard to make sense of it.

The interview comments reflect this:

"Most of my companies do discuss long-term value creation but there is often almost no disclosure on the operational metrics/KPIs you might need to track the success or failure. In the end we track pretty standard things like margins, growth trends."

Sell-side analyst

In the meantime, organisations and academics, such as the Sustainability Accounting Standards Board (SASB)²⁴ and the International Integrated Reporting Council (IIRC)²⁵ continue to publish research that shows how ESG factors are relevant and material to the success or failure of an investment.

²² The UN Sustainable Development Goals (SDGs) is a set of seventeen aspirational 'Global Goals' with 169 targets between them. The SDGs aim to end poverty, fight inequality and injustice and tackle climate change by 2030. The goals were endorsed by the United Nations General Assembly on 25 September 2015 by heads of government from 193 Member States. The 17 global goals cover areas such as poverty, hunger, education, economic growth, climate, sustainability and more. www.globalgoals.org

²³ Glassdoor holds a database of millions of user generated content, containing company reviews, CEO approval ratings, salary reports, interview reviews and questions, benefits reviews, office photos and more.

²⁴ The Sustainability Accounting Standards Board (SASB) is an independent 501(c)3 non-profit. SASB's mission is to develop and disseminate sustainability accounting standards that help public corporations disclose material, decision-useful information to investors. That mission is accomplished through a rigorous process that includes evidence-based research and broad, balanced stakeholder participation. www.sasb.org

²⁵ The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs. The coalition is promoting communication about value creation as the next step in the evolution of corporate reporting. www.integratedreporting.org

7. Difficulties in incorporating non-financial, long-term, broad-based issues into investment theses

It is clear from the survey and interviews that many analysts do not know how to incorporate ESG issues into their investment theses. Some clearly do not see some ESG issues as material; others say there are not any standard industry metrics or analyses that can be incorporated into investment decisions. The following comment is representative.

“Some companies talk about employee engagement, but I don’t think any have published an employee engagement survey. The problem is there is no standardisation. There has been more progress on customer satisfaction scores that companies have started talking about much more, but then the net promoter score is widely recognised.”

Sell-side analyst

Analysts responding to the survey said they already get very little time with management, and to assess ESG “you need a lot of time with management”.

“To assess culture you need a lot of time with management and that is not always possible.”

Sell-side analyst

We also believe there is a misunderstanding about what ESG is. Take the following comment, for example:

“When Barclays made an effort to change its culture, no-one cared on the buy-side or sell-side. The banking crisis was due to an over-extended loan book. It was a problem right through the system. It was not due to a culture in banks.”

Sell-side analyst

This statement does not seem to recognise that taking undue risks in bank loan books is in itself a reflection of culture.

This is despite the fact that since the financial crisis banks have identified culture as one of the major contributors to the crash and a risk to future conduct.

It would be helpful if training on long-term sustainability issues were made compulsory as part of analysts’ accreditation process. There is already a huge library of work on the material aspects of ESG. However, mainstream analysts may not be aware of this work or the initiatives taking place to promote better disclosure of ESG issues.

CONCLUSION & RECOMMENDATIONS

Sell-side analysts continue to have significant influence on the allocation of capital. But the pressures and commercial conflicts they are under are leading them to produce research that looks to enhance the profitability of investment banks at the expense of an efficient and properly functioning capital market.



Our findings indicate the current system does not encourage or incentivise sell-side analysts to consider long-term, broad-based research. As many as 90 per cent of mainstream analysts would at least undertake some additional caution when writing on topics sensitive to the bank. Over a third of mainstream respondents readily acknowledge they should avoid damaging investment banking relationships if they are to have a successful career.

These commercial conflicts are well known, and derive from the function of investment banks that intermediate between issuers and investors in capital markets. The information produced by an analyst who works in the research department can be of use to the bank's investment bankers. To disparage a client or potential client of the investment bank would not, therefore, be beneficial for the bank or for the analyst's career.

This has consequences for the efficient functioning of markets. Significantly, 42 per cent of analysts agree sell-side research has a detrimental short-term focus, and only 35 per cent agree that sell-side research tackles controversial topics and offers negative assessments of companies where appropriate. We also find that a mere 12 per cent

of mainstream sell-side analysts' time is spent researching companies' prospects beyond a 12-month horizon.

This suggests responsible investors with a long-term view need to ensure that the research payment accounts under Mifid 2 reward the right kind of research. Furthermore, policymakers should look carefully at these commercial conflicts on the sell-side if they want

capital markets to focus on the long term and allocate capital sustainably.

There are many challenges and it is clear analysts have to meet competing requirements when producing research coverage:

- Analysts perceive that the buy-side is not asking for long-term research or coverage of broader themes
- Many analysts would provide more in-depth research but feel unable to

do so because of efforts required on non-research activity and conflicts of interest.

- As well as internal challenges, analysts can also see external pressure from company management and IR on the tone of research coverage.
- Analysts do not often see companies and management telling the long-term story or building ESG performance into their overall strategy for the business.

It is clear it would be very difficult for an individual analyst or research team to overcome these hurdles and maintain a successful research franchise. Essentially the sell-side is behaving rationally within an irrational system.

Incentives within the whole investment chain need to change to support a longer-term economy that factors in all relevant and material financial and non-financial information.

The sell-side is just one part of a long chain of participants in the investment process – but a very important one. Research can be highly valued and influential in how the buy-side makes investment decisions, and, in turn, the way capital is allocated to companies.

It needs to become rational and an increasingly commercial decision in a post-MIFID2 world, for sell-side research to consider long term, wider sustainability issues. Policymakers, regulators and all market participants should seize the opportunity that MIFID2 implementation presents – which changes how asset managers pay for the research they use to make investment decisions – to encourage and incentivise this change.

Our research confirms the view that more needs to be done to promote a long-term focus and a consideration of broader issues. The time is right for policymakers and all market participants to review the incentives and motives along the whole investment chain.

We hope this paper will contribute to discussions on how various conflicts and challenges can be resolved. We have made some preliminary suggestions for change that span the entire investment chain – from companies through to asset managers - and policymakers.

We believe the whole eco-system within which analysts operate must continue to change if sell-side research is to reflect the longer term and material non-financial matters.

Our recommendations can be found on pages 4 to 5.

NEXT STEPS

We would like the various constituents of the investment chain mentioned in this study to discuss these initial recommendations. We look forward to a shift towards longer-term, broad-based ESG research.

APPENDIX ONE

RECENT REGULATORY DEVELOPMENTS THAT WILL AFFECT SELL-SIDE RESEARCH

The Markets in Financial Instruments Directive (MIFID2)²⁶

Until very recently, investment research has been widely available and effectively ‘free’, as analysis was generally paid for through commission sharing agreements or ‘soft commissions’. These are arrangements that allow asset managers to ask their executing broker for trade execution to allocate a portion of the commission directly to an independent research provider. In effect, they receive research from a counterparty in exchange for using its brokerage services. This is about to change.

MIFID2 represents a comprehensive and profound set of reforms that will reshape the financial markets, the products and services that banks provide and the relationship between banks, brokers and their customers. They are required to be transposed into national law by 3 July 2017 and must apply within EU Member States by 3 January 2018. Of particular relevance to sell-side analysts is the requirement that research must be unbundled from execution fees. In effect, an investment firm must pay for the research directly with its own funds or pay for such research from a designated research payment (RPA) account funded by specific charges on its clients.

What will change? Put simply, asset managers are now preparing for a world in which the research and advice they receive must be paid for directly, not through trading commissions, having grown used to such research being ‘free’.

MIFID2 and other initiatives underway are designed to make the costs of investing, for the ultimate investor, explicit, transparent and connected to the value derived from such costs. This will likely mean that less money is spent on research and less is provided by fewer suppliers. This is not pure supposition. Estimates of research commission paid in 2015 and 2016 show a 15 per cent decline on previous years.

How will investment banks or brokerage firms ie.the sellside respond? They will need to adapt and change in order to prosper. The sell-side tend to say they only want to do what their clients on the buy-side tell them to do. Sell-side firms are no different from other service providers, their existence and ability to do business relies on being close to clients and responding effectively to client needs and they will continue to do this.

This new framework is transformational and will impact the buy-side/sell-side relationship. This gives asset managers a real chance to influence this debate. If the buy-side makes it clear that it expects, needs and values a far greater focus on long-term sustainable research, then practice and habit will change and the sell-side will respond. It is a clear way for sell-side analysts to differentiate themselves from peers and offers a degree of protection in a fiercely competitive environment. It would align the research with the needs of long asset managers to invest over the long-term and deliver long term performance.

²⁶ FCA Asset Management Market Study - Final Report , MS15/2.3, June 2017.

FCA study into Asset Management ²⁷

At the same time that MIFID2 discussions were taking place in 2015-'16, the Financial Conduct Authority (FCA) announced its intention to undertake a study into the asset management market. The aim of the market study was to understand whether competition was working effectively to enable both institutional and retail investors to get value for money when purchasing asset management services. The FCA's interim report was published on 18 November 2016. The main finding was that there was weak price competition in a number of areas of the asset management industry and this had a material impact on the investment returns of investors through their payments for asset management services.

The final report was published in June 2017. In that document the FCA confirmed its support for the disclosure of a single all-in fee to investors and MIFID2 will introduce this for investors using intermediaries. This will include the asset management charge and an estimate of transaction charges. The FCA also supports consistent and standardised disclosure of costs and charges to institutional investors and work will continue to develop this further. The upshot of these changes is that the FCA transparency rules will put even more pressure on asset managers to justify their costs to clients. This, in turn, is likely to put further pressure on payment for investment research. Therefore, it becomes even more important commissioned research is insightful and adds value.

Trading costs will also need to be disclosed under FCA rules, and this may encourage more asset managers to focus on the risks and opportunities over the long-term in order to trade less often. From a practical point of view, this bolsters the case for longer-term research.

It may be interesting to note at this point that Aviva Investors gave evidence to the Business, Innovation and Skills Select Committee on The Kay Review of UK Equity markets and Long-term Decision Making in 2013. Our suggestion was that equity commissions earned on all trades made by an asset manager should be directed towards brokers and independent research providers of long-term investment research, voting advice and stewardship work.

It would be helpful for the FCA and MIFID2 guidance to express the sentiments above; that is to say payments should be directed towards longer term research to encourage longer-term, broader research that will allow long-term investors to be better long-term stewards of clients' money. Statements by Theresa May appear to acknowledge the benefits of long-term thinking in financial markets that is inclusive of broader issues. The Government response to the BEIS Green Paper on Corporate Governance reform²⁸ reinforce the importance of engaging employees, customers, suppliers and wider stakeholders to improve boardroom decision-making.

²⁷ FCA Asset Management Market Study - Final Report , MS15/2.3, June 2017.

²⁸ Department for Business, Energy and Industrial Strategy (BEIS) **Corporate Governance Reform. The government response to the Green Paper consultation**, August 2017.

APPENDIX TWO

Sell-Side Research Online Survey

There are claims that sell side-research places too little focus on long term and broader factors such as culture, governance, environmental impact and long-term risks. We are looking to test this claim.

The responses will be the subject of a paper that will highlight possible courses of action, if any, that can be taken to produce longer term research and help reduce pressures that negatively impact on your work.

Please be assured that your responses will be totally confidential and anonymous. We have not asked for names or organisations, only that you confirm that you have, or continue to, produce sell-side research.

This is a survey for a research project being conducted by Tomorrow's Company, Aviva Investors and Extel. Tomorrow's Company is a non-profit think tank that exists to inspire and enable business to be a force for good in society.

Quality of research

1. To what extent does sell-side research influence investor behaviour? (1 = none, 5 = significantly)
2. To what extent does sell-side research influence company behaviour? (1 = none, 5 = significantly)
3. Do you agree with the following statements on the quality of sell-side research (1 = strongly disagree, 5 = strongly agree)
 - "Sell-side research tackles controversial topics and is negative on companies where appropriate"
 - "Sell-side research has a detrimental short-term focus"
 - "Sell-side research effectively incorporates analysis of broader and non-financial topics"
 - "Sell-side research produces too much noise, instead of in-depth analysis"
 - "Sell-side research helps create a dialogue within financial markets that is supportive of long-term value creation in companies"
4. How important are the following factors to having a successful career as a sell-side analyst? (1 = not important, 5 = very important)
 - Valuation
 - Company culture
 - Capital allocation
 - Labour relations
 - Employee engagement
 - Customer loyalty
 - Standard of governance
 - Recent financial performance
 - Environmental impact
 - Upcoming catalysts
 - Quality of management
 - Executive remuneration
 - Strategy
 - Succession planning
 - Auditor independence
 - Aggressive or conservative accounting
5. What is your current allocation of time between the following activities?
 - Running models
 - Preparing and responding to quarterly results
 - Responding to news-flow
 - Client calls and meetings
 - Corporate roadshows
 - Company and sector research, up to a 12-month horizon
 - Company and sector research, longer than a 12-month horizon
6. Any comments on the quality of sell-side research?

Incentives and potential conflicts of interest

1. How important are the following factors to having a successful career as a sell-side analyst? (1 = not important, 5 = very important)

- Regular client contact
- Good stock calls
- Writing in-depth research
- Well regarded by internal sales and trading floor
- Being on top of the news flow
- Strong relationship with investor relations
- Produce research that supports, or doesn't damage, investment banking activity, e.g, IPOs
- Produce research that generates trading activity

2. What degree of pressure do you feel from the following groups that influences or constrains the research that you write? (1 = no pressure, 5 = significant pressure)

- Sales
- Trading
- Compliance
- Investment banking
- Investor relations
- Buy-side clients
- Research management

3. If you were considering writing research that was sensitive to the bank, or would damage the banks interests elsewhere, such as a sell rating. How much additional caution would you undertake? (1 = very cautious, 5 = no additional caution, I would approach it as if it were any other research report)

4. How often are you asked a question from the buy-side on broader and longer-term factors? Such as governance, culture, environmental and social impact? (once a week, once a month, once a quarter, once a year, never)

5. How often do companies integrate the broader and longer-term factors into their story of value creation and disclosure? (1 = never, 5 = always)

6. How would you restructure sell-side research to overcome conflicts of interest that prevent you writing what you want and to improve outcomes for savers and companies?

7. Do you have any examples of where broader and longer-term analysis provided a warning sign, but were ignored? For example, the VW emissions scandal, Tesco accounting, BP cost cutting over safety, US coal prices and sub-prime mortgages.

APPENDIX THREE

ACADEMIC EVIDENCE OF ESG AND PERFORMANCE

DATE	BY	TITLE	ABSTRACT: WHAT IT MEASURED	OUTCOME	THEME
Mar-17	Andreas G F Hoepner and Marcus A Nils-son, University of Reading	No news is good news: Corporate Social Responsibility Ratings and Fixed Income Portfolios	In response to the development of socially responsible investment (SRI) numerous ESG rating providers have been established. These companies provide ESG ratings and screens on companies. As investors are becoming more and more aware of the potential risk and opportunities associated with ESG factors, they use these ratings to identify ESG risks or opportunities that may not be captured through conventional analyses when constructing their portfolios. The question whether integrating ESG ratings into the investment process can increase performance has been investigated in stock portfolios. The results of some of these studies suggest that a strategy based on buying stocks with high ESG ratings and sell stocks with low ESG ratings can lead to abnormal returns (Kempf & Osthoff, 2007). This paper extends this literature by exploring this question in the area of fixed income by investigating if a trading strategy in bonds, based on ESG ratings on the issuing company, lead to abnormal returns.	Using a sample of 5240 bonds from 425 US companies during the period January 2001 to December 2014 and ESG ratings provided by KLD, this paper finds that bonds issued by companies with no strengths, no concerns, and no controversies significantly outperform the market benchmark. This paper shows that no news is good news in ESG fixed income portfolios. These findings are particularly strong in times of market turmoil, and results are shown to be robust when controlling for differences in remaining maturity. Bonds are priced on the perception of riskiness, and no news appears to result in investors perceiving them as less risky over time while news seems to result in investors perceiving them as riskier.	ESG
Feb-17	Patrick Velte, Leuphana University of Lueneburg	Does ESG performance have an impact on financial performance? Evidence from Germany	This paper concentrates on environmental, social and corporate governance (ESG) performance in total and divided in each component and their impact on financial performance. The study covers a sample selection of companies listed on the German Prime Standard (DAX30, TecDAX, MDAX) for the business years 2010-2014 (412 firm-year observations). A correlation and regression analysis are carried out in order to evaluate possible links between ESG performance as determined by the AssetFour database of Thomson Reuters and accounting and market-based measures of financial performance (ROA and Tobin's Q).	ESG performance has a positive impact on ROA but no impact on Tobin's Q. Furthermore, by analyzing the three different components of ESG performance, corporate governance performance has the strongest impact on financial performance in comparison to environmental and social performance.	ESG
Feb-17	Khan, Serafeim and Yoon	Corporate Sustainability: First evidence on materiality	Tests the emerging concept of 'materiality' – the differential importance of different sustainability issues across industries. Exploiting newly available materiality classifications of sustainability issues, the study handmaps issues classified as material for industries into firm-specific sustainability ratings. Industry classifications are developed by the Sustainability Accounting Standards Board through an extensive process of internal staff research, industry working group and public consultation. Firms are scored against these issues with KLD data. The sample consists of 2307 unique US firms for the period 1993–2013.	A portfolio of firms that score high on material issues and low on non-material issues generates annualised risk-adjusted returns of 4.83%. A portfolio of firms with both high performance on material issues and nonmaterial issues, by contrast, generates returns of 1.5%. The fall-off is even more marked for firms that neglect material issues. For a portfolio with low performance on material issues/high performance on nonmaterial issues, risk-adjusted returns are -0.38%. For a portfolio that performs poorly on both material and nonmaterial issues, returns are - 2.20% (all calculated on a value-weighted basis with quartile cut-offs). The correlation between materiality and immateriality scores is moderate (0.3), indicating that sustainability investments are related but sufficiently dissimilar to have different strategic and operational trade-offs for firms. This reinforces the importance of firms distinguishing between the types of investments they make and thinking about sustainability in concrete, not abstract terms. Not all sustainability issues are equally material: firms with good ratings on material sustainability issues significantly outperform firms with poor ratings on these issues. A portfolio of firms that score high on material issues and low on nonmaterial issues generates annualised risk-adjusted returns of 4.83%. A portfolio of firms with both high performance on material issues and nonmaterial issues, by contrast, generates returns of 1.5%. The fall-off is even more marked for firms that neglect material issues. For a portfolio with low performance on material issues/high performance on nonmaterial issues, risk-adjusted returns are -0.38%. For a portfolio that performs poorly on both material and nonmaterial issues, returns are - 2.20% (all calculated on a value-weighted basis with quartile cut-offs). The correlation between materiality and immateriality scores is moderate (0.3), indicating that sustainability investments are related but sufficiently dissimilar to have different strategic and operational trade-offs for firms. This reinforces the importance of firms distinguishing between the types of investments they make and thinking about sustainability in concrete, not abstract terms.	materiality of sustainability issues
Jan-17	NN Investment Partners and ECCE (European Centre for Corporate Engagement)	The materiality of ESG factors for emerging markets equity investment decisions: Academic evidence	The paper looks to understand how ESG factors affect share price performance in emerging markets equities and to help implement a successful ESG-focused investment policy within the asset class.	The study finds that ESG ratings and changes in ESG ratings help to produce 'high ESG' emerging market portfolios that outperformed their 'low ranked' counterparts, provided that levels of ESG scores are adjusted for sector/country effects prior to stock selection. Without controlling for country effects, stocks with high levels of ESG underperformed those with low levels of ESG. The results also provides some support for the position that companies in emerging markets might be more vulnerable to governance issues stemming from disproportionate control in the hands of a few shareholders to the detriment of firms' stock market performance. It also finds that excluding stocks based on Sustainably tics' indicators of ESG controversies improves the Sharpe ratio of an emerging markets portfolio.	Materiality of ESG factors

DATE	BY	TITLE	ABSTRACT: WHAT IT MEASURED	OUTCOME	THEME
Nov-16	Dimitris Melas, Zoltan Nagy and Padmakar kulkarni	Factor Investing and ESG integration.	Dimitris Melas, Global Head of Equity Research, discusses the relationship between ESG characteristics and traditional risk factors, and the impact of ESG integration on different investment strategies. Factor investing and ESG integration	The results showed that integrating ESG criteria into passive and factor strategies generally improved risk-adjusted performance over the period 2007 to 2016 and tilted the portfolio towards higher quality and lower volatility securities. They also show that the impact of ESG integration on target factor exposures and therefore on the ex-ante information ratio of these strategies is relatively moderate and varies according to the primary objective and target factors of the underlying strategy.	ESG
Oct-16	Robert Gutsche, Jan-Frederic Schulz, Michael Gratwohl, University of St. Gallen-School of Finance	Firm-Value Effects of CSR Disclosure and CSR Performance	We examine in this paper the effects of corporate social responsibility (CSR) disclosure and CSR performance on firm value for S&P 500 firms from 2011 to 2014. We find that CSR disclosure is positively associated with firm value and that the effect of CSR disclosure on firm value is larger than the effect of CSR performance	On average, the overall firm value increase for one index point of Bloomberg's environmental, social, and governance (ESG) Disclosure Score is \$260 million, whereas the increase for one index point of the Asset4 ESG Performance Score is below \$90 million. Moreover, we find that CSR performance scores related to the environment and governance are positively associated with firm value while the social score is negatively associated. Our results suggest that CSR disclosure mediates CSR performance. Based on prior research, we argue that CSR disclosure tends to be positively biased and too complex to be processed properly. We conclude that a relatively high amount of CSR disclosure is misinterpreted as good CSR performance.	ESG
Oct-16	LK Lins, H Servaes and A Tamayo	Social capital, Trust and firm performance: The value of corporate Social Responsibility during the financial crisis	Investigates the extent to which a firm's social capital benefited performance during the 2008-2009 financial crisis. CSR strength is deemed an appropriate proxy for firm-level social capital, which has support in empirical work, though is not the only metric and has its limitations. The sample consists of 1841 US non financial firms with CSR data available on the MSCI ESG stats database	Social capital provides valuable insurance during periods of investor and economic uncertainty when there is a premium on being identifiably trustworthy. High CSR firms have crisis-period stock returns that are four to five percentage points higher than for low CSR firms, though the impact of CSR on returns is not entirely linear across the distribution: the greatest improvement in returns is linked with a move from the lowest to the 2nd quartile of CSR and with a move from the 3rd to the 4th quartile. The contribution of social capital to returns is at least half as large as the effect of cash holdings and leverage. High-CSR firms also enjoy superior operating performance during this period that appears to accrue through customer and employee channels. For instance, customers are more willing to stick with firms during bad times, as reflected in higher sales growth and an acceptance of higher mark-ups. These findings generalise to other 'crisis' periods – for instance the Enron/WorldCom accounting scandals of the early 2000s. On the other hand, high CSR firms do not seem to earn excess returns in the period of high economic growth before the crisis (January 2004–July 2008) or after the crisis (April 2009–December 2013) which prima facie departs from the findings of other studies.	Sustainability culture
Oct-16	Barclays	Sustainable investing and bond returns	In investigating the link between ESG and corporate bond performance, Barclays Research constructed broadly diversified portfolios tracking the Bloomberg Barclays US Investment-Grade Corporate Bond Index. They matched the index's key characteristics (sector, quality, duration) but imposed either a positive or negative tilt to different ESG factors.	The findings show that a positive ESG tilt resulted in a small but steady performance advantage. No evidence of a negative performance impact was found. ESG attributes did not significantly affect the price of corporate bonds. No evidence was found that the performance advantage was due to a change in relative valuation over the study period. When applying separate tilts to E, S and G scores, the positive effect was strongest for a positive tilt towards the Governance factor, and weakest for Social scores. Issuers with high Governance scores experienced lower incidence of downgrades by credit rating agencies. Broadly similar results were observed using ratings from the two ESG providers considered in this report despite the significant differences between their methodologies.	ESG
Sep-16	Amir Amel-Zadeh, University of Oxford - Said Business School	The materiality of ESG factors for equity investment decisions: Academic evidence	The purpose of this study is to consolidate the existing body of knowledge on the materiality of nonfinancial information, particularly environmental, social and governance (ESG or sustainability) disclosures, by reviewing the theoretical and empirical evidence on this topic drawing from the academic literature in accounting, economics, finance, law, and management. The paper discusses the theoretical foundations of the concept of materiality and presents evidence on the changing views on the materiality of nonfinancial disclosures from the perspective of the securities and disclosure regulation in the U.S. It relates the arguments for the materiality of nonfinancial information to the stakeholder theory of the corporation. Building on the conceptual foundations the study then reviews the theoretical and empirical evidence in the management literature on corporate social responsibility, the accounting literature on sustainability disclosures and the economics and finance literature on responsible investing.	This study reconciles and extracts new insights from the existing evidence in these various fields in order to inform the academic debate on the materiality of nonfinancial disclosures and to open new avenues for research.	ESG
Sep-16	Morgan Stanley & Co. International plc.	Gender diversity continues to work	We launched a comprehensive quantitative framework to assess ~1,600 developed market companies on five themes related to gender diversity in our report Putting Gender Diversity to Work: Better Fundamentals, Less Volatility (02 May 2016).	We find continued evidence that gender diversity matters for stock price volatility in today's work. Among stocks ranked in the top quintile of our global stock selection model, those with high gender diversity have delivered much better risk adjusted stock returns than the rest over the past few months. With similar level of returns, high gender diversity stocks have exhibited lower performance volatility and had lower probability of experiencing a major drawdown. The diversity framework appears to be accretive to our current stock ranking model that focuses on common ranking areas like sentiment, revisions, valuation, technicals, balance sheet, and capital use.	Gender Diversity

DATE	BY	TITLE	ABSTRACT: WHAT IT MEASURED	OUTCOME	THEME
Sep-16	Tim Verheyden, Robert Eccles and Andreas Feiner	"ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification"	The paper explores whether a portfolio manager would be at a disadvantage in terms of performance, risk and diversification if he/she were to start from a universe that has been already screened based on ESG criteria. The paper presents an empirical analysis for two equity universes (a) "Global All" large and mid cap stocks across 23 developed and 23 emerging countries that jointing account roughly for 85% of the global equity universe; (b) "Global Developed Markets" the developed market subset of "Global all" which accounts roughly for 85% of the global developed equity universe	The empirical evidence shows that all ESG-screened portfolios have performed very similarly to their respective underlying benchmarks, if not slightly outperforming them. Excluding the bottom 10% (for both universes) or 25% of stocks (only for the "All" universe) based on ESG ranking is shown to have a small benefit in terms of increasing the average return and reducing the volatility, hence improving the risk-adjusted performance of the portfolio (most likely statistically insignificant though; the paper does not report the statistical strength of the results). These small benefits seem to be primarily driven by the fact that the stocks in the screened universe exhibit less downside risk compared to the entire population. Put differently, the findings of the paper show that – at the very least – there is no performance penalty from screening out low ESG-scoring firms of each industry	ESG
Jul-16	Jamieson Odell, Caravel Management LLC, Usman Ali, Caravel Management LLC	ESG Investing in Emerging and Frontier Markets	The authors discuss the benefits of considering material environmental, social, and governance (ESG) factors when investing in emerging and frontier markets.	Companies that operate in these markets face a myriad of operating challenges, and management teams that respond to such challenges effectively can achieve superior financial performance over time. They are able to grow faster, achieve higher profitability, reduce their cost of capital, and manage exogenous risks better than their peers. For investment managers, integrating sustainability into the analysis process provides a differentiated lens to identify companies that possess strong competitive advantages that can drive value creation over time. At the same time, it can help investment managers avoid companies that have embedded risks in their business model or operations that may not be entirely visible to the market. Finally, given the early-stage nature of many of these markets and the sometimes uneven understanding of sustainability issues at a company level, the authors argue that active ownership can be an important driver of alpha generation by fund managers. Engaging constructively with board members and management teams to improve a company's ESG profile can help drive operational improvements, strengthen the risk management function, and upgrade investors' perception of the quality of the management team	ESG
Jul-16	Steve Lydenberg, Domini Social Investments	Integrating Systemic Risk into Modern Portfolio Theory and Practice	Conventional wisdom holds that the performance of investment managers should be measured against some broad market index such as the S&P 500. The broad market averages provide a useful benchmark because they are assumed to be beyond the influence of investment managers and provide a way of capturing what financial economists call "systematic risk," which is the part of total risk that cannot be avoided through portfolio diversification. But one clear limitation of such an approach to performance evaluation is that by focusing on risks and rewards at the portfolio level only, it fails to consider risks and rewards at a systemic level, where the performance of all portfolios is increasingly likely to be affected.	The author begins by making the case that the performance evaluation and collective decision-making of investment managers could have the effect of increasing the level of systematic risk in both the markets and the real economy. Then, after suggesting that the strength or weakness of environmental, social, and governance (ESG) frameworks can have substantial effects on overall market returns, he discusses a number of efforts currently underway to integrate ESG factors into portfolio-level decision-making. The author closes by urging asset owners to take the following three steps to help bridge the gap between investment decision-making and ESG consequences: (1) acknowledge the connection between investment decision-making and systems-level risks and rewards; (2) determine which systemic frameworks are most appropriate and useful for their purposes; and (3) implement investment practices that allow them to manage systemic-level risks and rewards while simultaneously achieving competitive financial returns in their portfolios. With the help of new measurement and management tools, asset owners can strengthen systemic frameworks, communicate the importance of ESG performance to their investees and investors, and align their efforts with those of governmental and non-governmental organizations to limit systemic risk.	ESG
Jun-16	Vanita Tripathi and Varun Bhandari, University of Delhi	Performance evaluation of socially responsible stocks portfolios across sectors during different economic conditions	This paper examines the performance of socially responsible companies in different sectors along with general companies using return and various risk-adjusted measures over the period January 1996–December 2013 and over different business economic conditions. Besides the conventional techniques, we have used modified Sharpe ratio, double Sharpe ratio, M2 measure, three factor alpha using FamaFrench model and Fama's decomposition measure. We have also checked whether market model is sufficient to explain cross sectional variations across portfolios or we need a three factor model.	We find that IT and FMCG sector portfolios are well rewarding during different boom and recession periods respectively by generating significantly higher returns and outperforming general companies in terms of risk-adjusted measures. We also find that irrespective of economic condition. Socially responsible companies are performing well in Indian stock market by producing significant abnormal returns. Thus, our results clearly corroborate this fact that SRI in India should be considered as a mainstream form of investing by investors and portfolio managers. The study supports the view that significant higher returns of socially responsible companies than general companies make SRI a better investment vehicle for investment in India. Therefore, general companies should imbibe the spirit of social responsibility and start considering ESG issues as their investment themes.	ESG

DATE	BY	TITLE	ABSTRACT: WHAT IT MEASURED	OUTCOME	THEME
Jun-16	Sakis Kotsantonis, Independent, Chris Pinney, High Meadows Institute, George Serafeim, Harvard University	ESG integration in investment management: Myths and Realities	The number of public companies reporting ESG information grew from fewer than 20 in the early 1990s to 8,500 by 2014. Moreover, by the end of 2014, over 1,400 institutional investors that manage some \$60 trillion in assets had signed the UN Principles for Responsible Investment (UNPRI). Nevertheless, companies with high ESG "scores" have continued to be viewed by mainstream investors as unlikely to produce competitive shareholder returns, in part because of the findings of older studies showing low returns from the social responsibility investing of the 1990s. But studies of more recent periods suggest that companies with significant ESG programs have actually outperformed their competitors in a number of important ways. The authors' aim in this article is to set the record straight on the financial performance of sustainable investing while also correcting a number of other widespread misconceptions about this rapidly growing set of principles and methods.	Myth Number 1: ESG programs reduce returns on capital and long-run shareholder value. Reality: Companies committed to ESG are finding competitive advantages in product, labour and capital markets; and portfolios that have integrated "material" ESG metrics have provided average returns to their investors that are superior to those of conventional portfolios, while exhibiting lower risk. Myth Number 2: ESG is already well integrated into mainstream investment management. Reality: The UNPRI signatories have committed themselves only to adhering to a set of principles for responsible investment, a standard that falls well short of integrating ESG considerations into their investment decisions. Myth Number 3: Companies cannot influence the kind of shareholders who buy their shares, and corporate managers must often sacrifice sustainability goals to meet the quarterly earnings targets of increasingly short-term-oriented investors. Reality: Companies that pursue major sustainability initiatives and publicise them in integrated reports and other communications with investors, have also generally succeeded in attracting disproportionate number of longer-term shareholders. Myth Number 4: ESG data for fundamental analysis is scarce and unreliable. Reality: Thanks to the efforts of reporting and investor organisations such as SASB and Ceres and of CDP data providers like Bloomberg and MSI, much more "value-relevant" ESG data on companies has become available in the past ten years. Myth Number 5: ESG adds value almost entirely by limiting risks. Reality: Along with lower risk and a lower cost of capital, companies with high ESG scores have also experienced increases in operating efficiency and expansions into new markets. Myth Number 6: Consideration of ESG factors might create a conflict with fiduciary duty for some investors. Reality: Many ESG factors have been shown to have positive correlations with corporate financial performance and value, prompting ERISA in 2015 to reverse its earlier instructions to pension funds about the legitimacy of taking account of "non-financial" considerations when investing in companies.	ESG
Apr-16	ODDO Securities	Capital allocation: From the Board to Management, a major responsibility towards the stakeholders concerned	Analysed ten year cash flow situation of 165 large European companies.	Value creation in the long term requires balanced capital allocation. The study compared the average capital allocation with a series of five economic and financial indicators: EPS growth, ROE, RoIC, growth of assets and growth of the EBITDA margin. The companies presenting the strongest growth and profitability profile over 10 years allocates, on average, 32% to investment in tangible assets (vs. 40% for the weakest), 10% to acquisitions (vs. 7%), 26% to debt repayment (vs. 35%), 22% to the dividend (vs. 13%) and 10% to share buybacks (vs. 5%). There is a significant correlation (48%) between results on 'capital allocation criterion' and results on the quality of management	Quality of management and Capital Allocation
Apr-16	NN Investment Partners and ECCE (European Centre for Corporate Engagement)	The materiality of ESG factors for equity investment decisions: Academic evidence	The study aimed to gain new insights into the usefulness of environmental, social and governance (ESG) data for investment professionals.	The study established that the exclusion of organisations with controversial business practices can potentially improve investment results. The study looked into the connection between ESG factors and earnings and discovered that companies which strove to improve the ESG ratings tended to generate even better earnings than those which had already attained the highest rating.	ESG
Apr-16	Harvard Business Review	The business case for Purpose	EY Beacon Institute teamed with Harvard Business Review Analytic Services, surveying global business executives about the extent to which purpose is utilised by their organisations and, importantly, the impact that it has upon their ability to grow, innovate, and transform.	Found a very high level of consensus among these executives that purpose matters, and a widespread belief that it has positive effects on key performance drivers. The survey also demonstrates that companies who clearly articulate their purpose enjoy higher growth rates and higher levels of success in transformation and innovation initiatives.	Organisational purpose
Mar-16	Rick Di Mascio, Founder & CEO Inalytics	Does it pay to own companies that do the right thing	It measures company performance over time according to governance ratings provided by PIRC.	The original study was done in 2013 which found that the share prices of small and mid sized UK companies (bottom 20% by market cap of the FTSE All Share index) with stronger governance performed better than those with high levels of risk. The authors revisited the conclusion by extending the analysis to include data provided by PIRC covering the period from March 2010 to March 2015. The cumulative performance of the five governance ratings among smaller and mid sized companies were consistent with the earlier findings and demonstrate that companies with higher governance ratings have continued to perform more strongly. It is also striking that an investment in all the A rated small companies would now be worth more than double an investment in all the E rated small companies after less than six years.	Governance

DATE	BY	TITLE	ABSTRACT: WHAT IT MEASURED	OUTCOME	THEME
Feb-16	Hemlata-Chelawat, ML Sukhadia University and IV Trivedi, ML Sukhadia University	The Business Value of ESG Performance: The Indian Context	Today, business corporations across the globe are moving beyond the short-term myopic goal of profit maximization to long-term sustainability goals involving environmental, social and corporate governance (ESG) goals. This is due to the growing realization that ESG factors constitute a significant source of risk for the business and can affect their financial returns. Academic research has shown that improved ESG performance has lowered risk and enhanced financial performance but results seemed to vary widely across countries. Regrettably, this subject remains largely un-researched in the context of emerging economies, including India. This paper attempts to fill this much needed gap in sustainability literature in one of the largest emerging market economies, India. It empirically examines the impact of environmental, social and corporate governance (ESG) performance of companies on their financial performance, in India, using panel regression models.	The findings of the study indicate that good corporate ESG performance enhances financial performance. The findings of this study have important implications for investors, corporate management as well as policymakers and regulators.	ESG
Feb-16	Deutsche Asset Wealth Management & University of Hamburg	Deutsche Meta Study	In a new extensive analysis, based on more than 2,200 studies, Deutsche Asset & Wealth Management and the University of Hamburg investigate whether integrating ESG into the investment process has a positive effect on corporate financial performance. The study examines whether the effect was stable over time, how a link between ESG and CFP differs across regions and asset classes and whether any specific sub-category of E, S or G had a dominant influence on CFP.	The authors find that the business case for ESG investing is empirically well founded and that investing in ESG pays off financially and appears stable over time. Roughly 90% of studies find a non-negative relation with an overwhelming share of positive results: vote-count studies 47.9% and meta-analyses 62.6%. Less than 10% of the studies display a negative ESG-CFP relationship with the remainder (45.2% / 29.4%) showing a neutral relation of ESG and CFP (graphs available)	ESG
Jan-16	Credit Suisse	Overboarding in Europe	Tested their hypothesis that directors who sit on more than one board are faced with too many time demands and potential conflicts of interest for optimal decision making and the companies where the directors hold seats on multiple boards might underperform.	Their analysis supports this view. Over the past five years European benchmark index companies whose directors hold just one board seat have demonstrated a share price CAGR outperformance of 5.0% compared with companies whose directors hold two or more board seats. ROE at companies where directors only hold one board seat in Europe have been 2.3% higher, on average, since 2010 compared with companies where directors hold more than one board seat. The economic profit generated at companies where directors have just one board seat is 4 x higher than those companies where directors have more than one directorship	Governance
Jan-16	Zuraida Zuaida, Victoria, Nurul Houge, Victoria Victoria Business School, Tony van Zijl, Victoria University of Wellington	Value Relevance of Environmental, Social and Governance Disclosure	This paper investigates the impact of Environmental, Social, and Governance (ESG) disclosure by companies around the world on market value. Using a large sample of non-financial companies listed in 38 countries during the period 2008-2012, we test for value relevance by employing the modified version of the Ohlson (1995) model developed by Collins, Maydew, and Weiss (1997).	We find support for the value relevance of disclosure of ESG both in aggregate form and for its individual components. These findings support the expectation of disclosure theory that disclosure of relevant information (such as ESG) has a positive impact on value. The results are robust to several alternative specifications. Consistent with the finance literature on the impact of legal origin (La Porta, Lopez de Silanes, & Shleifer, 2006; La Porta, Lopez de Silanes, Shleifer, & Vishny, 1998, 2000, 2002), the results for ESG disclosure are stronger in common-law countries. Our results provide new evidence for researchers, investors, and policy makers of the value relevance of ESG disclosure in a broad international setting. The evidence shows that globally investors benefit from the disclosure of both aggregate ESG and the individual factors and this supports regulators in pushing companies to provide additional ESG information.	Disclosure of ESG
Jan-16	Meir Statman and Denys Glushkov	Classifying and measuring the performance of Socially Responsible Mutual Funds	The absence of clear criteria to distinguish socially responsible (SR) from conventional mutual funds makes it difficult to classify funds as SR and measure the effect of social responsibility on the investment performance. In their recent paper, Meir Statman and Denys Glushkov address these issues and develop a model that could help resolving them. In particular, the authors extend the Carhart (1997) four-factor model (market, small-large, value-growth and momentum) by adding two social responsibility factors: <ul style="list-style-type: none"> • Top Minus Bottom (TMB), which ranks companies according to their strengths and concerns on five ESG-related criteria: employee relations, community relations, environmental protection, diversity and products. The long (short) side of the TMB factor is a value-weighted portfolio consisting of companies that belong to the top (bottom) third of companies in at least two of the five criteria and not in the bottom (top) third of any criterion. • Accepted Minus Shunned (AMS), which is the difference between the returns of stocks commonly accepted in SR funds and those that are typically avoided. Shunned companies are those with operations in the tobacco, alcohol, gambling, military, firearms and nuclear industries. The long (short) side of the AMS factor is a value-weighted portfolio of accepted (shunned) stocks. 	The conclusions from this analysis are the following: <ul style="list-style-type: none"> • For any given level of AMS ("high", "medium" or "low"), increasing TMB always improves performance. The incremental changes in average alpha by moving TMB from "low" to "high" are reported as statistically significant. • For any level of TMB, increasing AMS seems to have a negative effect on performance; however, the decrease is not significant. These findings indicate that the lack of statistically significant differences between the performance of SR and conventional funds could be due to the investors' preferences for high TMB and high AMS exposure. In other words, mutual funds improve their performance by holding companies with strong ESG scores while imposing further industry restrictions detracts from it, resulting in a small net positive but insignificant effect.	ESG

DATE	BY	TITLE	ABSTRACT: WHAT IT MEASURED	OUTCOME	THEME
Nov-15	Merrill Lynch	Impact Investing: The Performance Realities	<p>The paper evaluates current impact investing by examining:</p> <ul style="list-style-type: none"> • What impact investing is and how it has evolved to be a viable investment approach • How investors can maintain returns in their portfolios while investing for impact • How ESG factors can be used to identify risks and opportunities in the market • Historical risk and returns from a range of impact investments • How investors can start accessing the impact investing marketplace today 	Smart use of impact data has been shown to help reduce portfolio volatility by helping managers identify risks beyond the balance sheet and even help spot opportunities in the marketplace. In fact, companies who demonstrate ESG prudence have been able to reduce risk and potentially enhance shareholder value. These benefits can help lead to enhanced risk management performance of a portfolio. (quotes some of the studies highlighted below). Page 7 of this study also says their own internal Merrill Lynch analysis shows that there are benefits to the risk adjusted return profile of a portfolio. Out of the actively managed public equity strategies that met both investment and ESG integration criteria, 60% outperformed other Investment Management & Guidance Analyst covers strategies, which on average have a higher risk adjusted return than the universe. Do impact investments also offer potential for alpha generation? The paper says that while multiple studies have emerged it is difficult to generalise about their conclusions and whether impact investing can generate superior returns in comparison to traditional strategies.	ESG
Jun-15	Zoltan Nagy, Altaf Kassam and Linda-Eling Lee MSCI	"Can ESG add alpha? An analysis of ESG Tilt and momentum Strategies	The authors investigate the alpha-generating potential of two ESG-related portfolios; "ESG tilt" and "ESG momentum". The former is a strategy which overweights stocks with higher ESG ratings, the latter strategy overweights stocks whose ESG score has improved. The objective of both is to improve the overall ESG score relative to a benchmark.	The construction of the two ESG related strategies uses ESG scores (for ESG tilt) or change in ESG scores over the past 12 months (for ESG momentum) to overweight or underweight stocks. Both portfolios are shown to (a) outperform MSCI World during the aforementioned sample period and (b) achieve an overall improvement in their ESG score; 4 points for the ESG tilt portfolio (score of 9.8 versus 5.8 for the benchmark) and 1.7 points for the ESG momentum portfolio (score 7.4 versus 5.7). Regarding overall performance, the total active return for ESG momentum has been more than double that of ESG tilt. In other words, ESG score improvement is more strongly related to future performance than just the level of the ESG score. Overall, this analysis demonstrates that it is possible to construct a portfolio based on ESG scores that can outperform the benchmark whilst not deviating excessively from the benchmark composition.	ESG
Mar-15	Arabesque Asset Management and Oxford University	From the Stockholder to the Stakeholder How sustainability can drive financial out-performance	The report investigates over 200 of the highest quality academic studies and sources on sustainability to assess the economic evidence on both sides for (a) a business case for corporate sustainability and (b) integrating sustainability into investment decisions (c) implementing active ownership policies into investors' portfolios.	Findings suggest companies with strong sustainability scores show better operational performance and are less risky. Investment strategies that incorporate ESG issues outperform comparable non-ESG strategies and active ownership creates value for companies and investors. Based on their results, it was concluded that it is in the best economic interest for corporate managers and investors to incorporate sustainability considerations into decision making processes.	ESG
Jan-15	Breckenridge Capital	ESG Integration in Corporate Fixed Income	In this commentary, we review the merits of ESG analysis as well as our integration process. We also share what can be gained by incorporating this non-financial analysis into credit research. Finally, we summarize a number of corporate sustainability trends and share key takeaways of our 2014 corporate engagement project.	Shows that using ESG factors enhanced an investment manager's ability to perform credit analysis and evaluate risk management more broadly - so much so that the firm now uses ESG factors in all its investment decisions. The correlations of ESG factors to financial factors were found to be very low and when using these factors Breckenridge was able to identify additional credit risks. Furthermore they found that companies that manage their ESG risks tended to be more stable credit risks and had lower earnings volatility.	ESG
Sep-14	CDP	CDP S&P 500 Climate Change Report 2014	Used climate change disclosures from world's largest companies. CDP began scoring company responses to its questionnaire in 2007 to provide a gauge of the transparency of climate change information disseminated to the market. Companies receive a CDP disclosure score from 0 to 100 and performance band A to F. Companies who score in top 10% are included in an annual index known as the Climate Disclosure Leadership Index (CDLI). CDP's analysis is based on 337 company responses received by June 2014. Response rate of 70% at time of printing.	Found that S&P 500 industry leaders on climate change generated 18% higher ROE, 50% lower volatility of earnings over the past decade and 2% stronger dividend growth to shareholders than their low scoring peers.	Climate Change
Apr-14	Robert Eccles, Harvard / Business school, Ioannis, Ioannou London Business School, George Serafeim, Harvard business school	The impact of a corporate sustainability on organisational processes and performance	We investigate the effect of corporate sustainability on organizational processes and performance.	We find that corporations that voluntarily adopted sustainability policies by 1993 - termed as High Sustainability companies - exhibit by 2009 distinct organizational processes compared to a matched sample of companies that adopted almost none of these policies - termed as Low Sustainability companies. The boards of directors of High Sustainability companies are more likely to be formally responsible for sustainability and top executive compensation incentives are more likely to be a function of sustainability metrics. High Sustainability companies are more likely to have established processes for stakeholder engagement, to be more long-term oriented, and to exhibit higher measurement and disclosure of nonfinancial information. Finally, High Sustainability companies significantly outperform their counterparts over the long-term, both in terms of stock market and accounting performance.	Sustainability culture

DATE	BY	TITLE	ABSTRACT: WHAT IT MEASURED	OUTCOME	THEME
Oct-13	Deng, Kang and Low	Corporate Social Responsibility and Stakeholder Value Maximisation: Evidence from Mergers	Examines the impact of stakeholder maximisation on merger success, an important aspect of a firm's operations, though one with a high failure rate. The sample consists of 1,556 completed US mergers between 1992 and 2007. Examines the impact of stakeholder maximisation on merger success, an important aspect of a firm's operations, though one with a high failure rate. The sample consists of 1556 completed US mergers between 1992 and 2007	Firms with high CSR acquirers experience no significant change in post merger operating performance while firms with low CSR acquirers typically experience deterioration in their performance. A long/short strategy that buys acquirers with high CSR and sells acquirers with low CSR is able to generate annual risk adjusted returns as high as 4.8%, 3.6% and 3.6% for holding periods of one, two and three years respectively. Mergers proposed by socially responsible firms have a higher likelihood of being completed in less time. Major customers and suppliers of firms acquired by high CSR firms realise higher merger announcement returns than ones acquired by low CSR firms. Acquirers bondholders also benefit. The CSR status of the acquirer firm matters more to performance than the CSR status of the target firm. This echoes other evidence that acquisitions of firms with weak governance by well governed firms create higher synergistic gains. The main results persist even after taking into account the agency cost components of CSR policies and the role of unionisation. Note that the study only considers merger, not acquisitions. The results do not hold for acquisitions.	ESG
Jun-12	DB Climate Change Advisors, Deutsche Bank Group	Sustainable investing: Establishing Long-Term Value and Performance	The study looked at more than 100 academic studies of sustainable investing around the world and examined and categorised 56 research papers, 2 literature reviews and 4 meta studies.	Found that companies identified as having high CSR or ESG rankings historically have had strong correlation with superior risk adjusted securities returns. These companies typically have a lower cost of debt capital and equity, which is likely a reflection of the market rewarding them with a lower cost of capital in exchange for lower risk. However, in the same study, companies designated as having SRI qualities, which primarily use exclusionary screens, showed little additional benefit, although they did not underperform the broader market.	ESG
Jan-11	Michael E Porter and Mark R Kramer, Harvard Business Review	Creating Shared Value	The paper tests the concept of shared value which is defined as policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in the communities in which it operates. Shared value creation focuses on identifying and expanding the connections between societal and economic progress. The concept rests on the premise that both economic and social progress must be addressed using value principles. Value is defined as benefits relative to costs, not just benefits alone.	Firms that made a proactive commitment to being environmentally and socially responsible and are serious about good governance practices also referred to in much of the academic studies as 'sustainable companies' are generally better run, more profitable and enjoyed associated cost savings.	ESG
Jan-10	Alex Edmans, London Business School, ECGI and Centre for Economic Policy Research	Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices	This paper analyses the relationship between employee satisfaction and long-run stock returns. A value-weighted portfolio of the "100 Best Companies to Work For in America" earned an annual four-factor alpha of 3.5% from 1984-2009, and 2.1% above industry benchmarks.	The results are robust to controls for firm characteristics, different weighting methodologies and the removal of outliers. The Best Companies also exhibited significantly more positive earnings surprises and announcement returns. These findings have three main implications. First, consistent with human capital-centred theories of the firm, employee satisfaction is positively correlated with shareholder returns and need not represent managerial slack. Second, the stock market does not fully value intangibles, even when independently verified by a highly public survey on large firms. Third, certain socially responsible investing ("SRI") screens may improve investment returns.	Employee Satisfaction
Apr-09	Cary Krosinsky, Nick Robins	Sustainable Investing: The Art of Long Term Performance	The book looks at a number of aspects of sustainable investing including issues of how sustainable investing is different from socially responsible investing and how it is performing financially.	Found that a strategy identifying sustainable companies rather than simply screening out companies led to material outperformance for the period (five years trailing from end of 2007).	Sustainable investing

APPENDIX FOUR

An Introduction to Equity Capital Markets for Policy Makers²⁹

The capital markets are a place where debt and equity can be raised, bought and sold. They formally include markets for share capital, short and long-term loan capital (e.g. corporate bonds and bank loans) and government bonds. The equity market and money market are the two principal sources of external capital to industry.

The equity market is the key capital market in focus in this report and is defined as “a market where specialised intermediaries buy and sell securities under a common set of rules and regulations through a closed system dedicated to that purpose” (Michie, 1999, p3). To place this into its proper historical context, in the UK the London Stock Exchange was formally founded in 1801, with the first Official List of prices being issued in 1803. However, the market for securities pre-dates this time. From the 17th century onwards, with the appearance of national debt and transferable stocks issued by Joint Stock Companies such as the English East India Company (founded in 1623), the volume of business generated by securities was sufficient to warrant the beginnings of professional intermediation and organised markets (Michie, op cit).

The operations of the London Stock Exchange fall within the scope of the Financial Conduct Authority (FCA) in its role as the UK Listing Authority (UKLA). The FCA is an independent non-governmental body that has been given statutory powers by the Financial Services Act 2012. Its role is to ensure the system remains effective and credible by policing the stock exchange, investigating and, where appropriate, using its criminal prosecution powers against firms that have contravened market rules. The two principal functions of a stock exchange are to provide:

1. a primary market where companies can raise new investment capital by issuing new stocks, shares or corporate bonds;
 2. a secondary market for dealing in existing securities.
- Although referred to as a secondary market, this is by no means a secondary role as most of the trading that takes place is in previously issued securities.

The stock exchange allows the original owners of the firm to spread the risk of their company over a large number of investors by issuing shares. Similarly, it allows investors to spread their risk among a variety of shares, and to realise the current value of their investment by selling in the secondary market. The stock price represents the market’s view of the discounted value of future income streams (including dividends) and, at any one point, reflects the market’s aggregate view of the company’s financial value.

“Prospects for any particular company... [are] always uncertain. Some people rate the company... more highly than others. The market price is the average of everyone’s valuations, weighted by the amount of money they are able to mobilise behind their views” (Kay, 2003, p142)

The key capital market financial institutions and their inter-relationships

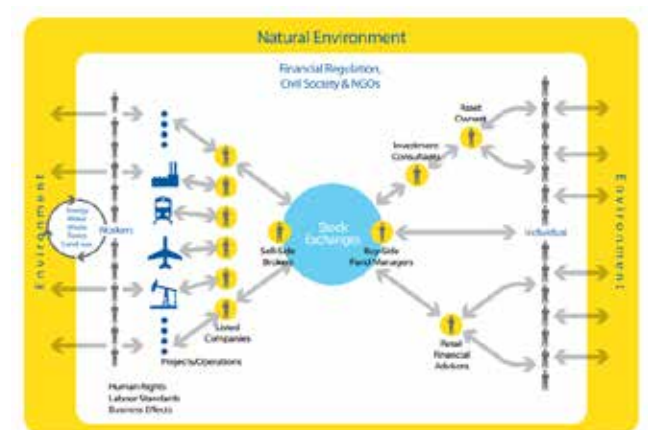
Stock exchange intermediaries and institutions include, among others, stockbrokers, fund managers, issuing houses, merchant banks (now more commonly called investment banks) and, as general buyers and sellers of securities, the central bank, commercial banks, pension funds, insurance companies, unit trusts, investment trusts, open-ended investment companies, and company treasuries. Here, they collectively represent the main types of capital market financial institutions in question.

It is necessary to set out how the main types of financial institutions relate to each other so we can be clear about the chain of influence that makes the capital markets of interest to policy-makers. The following describes the capital market institutions that facilitate the flow of capital from investors (who supply the capital) to companies (who demand the capital).

Figure 1 depicts the relationship between the financial institutions that operate the market between the demand for and supply of capital. The different roles of the financial institutions are important as each role reflects the nature of the influence. (This systems map also provided the structure for making Aviva’s recommendations for the UN Sustainable Development Goals.)

²⁹ First published in the Aviva White Paper: **A Roadmap for Sustainable Capital Markets**– Appendix 1, 2014.

Figure 1: The structure of the capital market



1. Individual Investors – individuals, either as scheme beneficiaries or directly as ‘retail’ investors, purchasing stocks and shares from an investment broker, or investing in pooled schemes such as OEICs, SICAVs, unit trusts and investment trusts managed by fund managers;
2. Institutional Investors – such as company and local authority pension funds, insurance companies, investment trusts, charities and organisations operating unit trusts and investment trusts.

The demand for equity capital comes from companies (PLCs) listed on stock exchanges. Globally, the value of all companies listed on stock exchanges in 2016 was over \$67 trillion³⁰. These PLCs use the services of investment banks to underwrite the new issues of their shares (it should be noted that in many developed markets the use of equity finance by listed companies is becoming a less significant source of capital for companies than finance via corporate debt – see, for example, Kay 2012).

Investment banks also have a role in facilitating mergers, acquisitions and new placements on the exchange. Furthermore, many investment banks include sell-side³¹ broker operations that act as intermediary agents between companies and investors, maintain markets for previously issued securities and offer advisory services to fund managers. This last advisory service role renders sell side brokers important to policymakers working on sustainable

development issues. Fund managers place considerable authority in the views of these analysts, with the consensus in their forecasts being a closely monitored factor by many analysts. Therefore, where the views of the most influential brokers change, markets also tend to move: consequently, the broker’s view on sustainable development issues will be influential.

Buy-side³² fund management houses buy and sell their equities via sell-side brokers. They may also use their advisory services. It is the job of the individual fund manager to make individual portfolio investment decisions in accordance with the stated aims of the investment fund, and may also employ their own internal analysts. The client’s aims are set out by the asset owners in the investment mandate, which is also known as the Investment Management Agreement.

Similar to retail investors seeking the advice of independent financial advisors (IFAs), institutional investors place considerable authority in the views of investment consultants, who advise as to which fund manager has the most robust investment process and can meet the investment needs of the investment scheme. This is particularly the case in, for example, the UK, the United States and Canada. Therefore, being able to articulate a robust investment process that impresses investment consultants is of central importance to fund managers. This is because they need to be able to convince the investment consultants that they have the people, investment philosophy and investment process to deliver consistent performance in order to win business. Consequently, fund managers spend a considerable amount of time and effort on the areas that investment consultants rate as important aspects of a good process.

Investment consultants are highly relevant to policymakers because they significantly influence an institutional investors’ choice of fund manager. As a consequence, if investment consultants indicate that they believe that something is important, this sends a powerful market signal to fund managers, who are more likely to invest more resources in this area as a result.

³⁰ World Federation of Exchanges www.world-exchanges.org

³¹ ‘Sell-side’ refers to institutions that sell equities to investors for a percentage commission.

³² ‘Buy-side’ refers to institutions that buy and hold securities in the expectation of a return on investment.

Important Information

Except where stated as otherwise, the source of all information is Aviva Investors Global Services Limited (Aviva Investors) as at 30 June 2017. Unless stated otherwise any views and opinions are those of Aviva Investors. They should not be viewed as indicating any guarantee of return from an investment managed by Aviva Investors nor as advice of any nature. Past performance is not a guide to the future. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested. Some of the information within this document is based upon Aviva Investors estimates.

Nothing in this document is intended to or should be construed as advice or recommendations of any nature. This document is not a recommendation to sell or purchase any investment. It does not form part of any contract for the sale or purchase of any investment.

In the UK & Europe this document has been prepared and issued by Aviva Investors Global Services Limited, registered in England No.1151805. Registered Office: St. Helen's, 1 Undershaft, London, EC3P 3DQ. Authorised and regulated in the UK by the Financial Conduct Authority. Contact us at Aviva Investors Global Services Limited, St. Helen's, 1 Undershaft, London, EC3P 3DQ. Telephone calls to Aviva Investors may be recorded for training or monitoring purposes.

In Singapore, this document is being circulated by way of an arrangement with Aviva Investors Asia Pte. Limited for distribution to institutional investors only. Please note that Aviva Investors Asia Pte. Limited does not provide any independent research or analysis in the substance or preparation of this document. Recipients of this document are to contact Aviva Investors Asia Pte. Limited in respect of any matters arising from, or in connection with, this document. Aviva Investors Asia Pte. Limited, a company incorporated under the laws of Singapore with registration number 200813519W, holds a valid Capital Markets Services Licence to carry out fund management activities issued under the Securities and Futures Act (Singapore Statute Cap. 289) and is an Exempt Financial Adviser for the purposes of the Financial Advisers Act (Singapore Statute Cap.110). Registered Office: 1 Raffles Quay, #27-13 South Tower, Singapore 048583.

In Taiwan, this document is being circulated by way of an arrangement with Aviva Investors Securities Investment Consulting Co., Ltd. for distribution to investment professionals only. Please note that Aviva Investors Securities Investment Consulting Co., Ltd., does not provide any independent research or analysis in the substance or preparation of this document. Recipients of this document are to contact Aviva Investors Securities Investment Consulting Co., Ltd., in respect of any matters arising from, or in connection with, this document. Aviva Investors Securities Investment Consulting Co., Ltd., a company incorporated under the Company Law of the Republic of China with registration number 53097616, holds a valid Securities Investment Consulting Enterprise (SICE) License to carry out Securities Investment Consulting Service and other relevant business permitted by Financial Supervisory Commission, Executive Yuan, R.O.C. and provides permitted liaison and co-ordination services only. Registered Office: Room D-1, 24F, No. 7, Section 5, Xin Yi Road, Taipei 110, Taiwan.

In Australia, this document is being circulated by way of an arrangement with Aviva Investors Pacific Pty Ltd for distribution to wholesale investors only. Please note that Aviva Investors Pacific Pty Ltd does not provide any independent research or analysis in the substance or preparation of this document. Recipients of this document are to contact Aviva Investors Pacific Pty Ltd in respect of any matters arising from, or in connection with, this document. Aviva Investors Pacific Pty Ltd, a company incorporated under the laws of Australia with Australian Business No. 87 153 200 278 and Australian Company No. 153 200 278, holds an Australian Financial Services License (AFSL 411458) issued by the Australian Securities and Investments Commission. Business Address: Level 50, 120 Collins Street, Melbourne VIC 3000, Australia.

For Use in Canada

Aviva Investors Canada, Inc ("AIC") is located in Toronto and is based within the North American region of the global organization of affiliated asset management businesses operating under the Aviva Investors name. AIC is registered with the Ontario Securities Commission ("OSC") as a Portfolio Manager, an Exempt Market Dealer, and a Commodity Trading Manager.

For Use in the United States

Aviva Investors Americas LLC is a federally registered investment advisor with the U.S. Securities and Exchange Commission. Aviva Investors Americas is also a commodity trading advisor ("CTA") and commodity pool operator ("CPO") registered with the Commodity Futures Trading Commission ("CFTC"), and is a member of the National Futures Association ("NFA"). In performing its services, AIA utilizes the services of investment professionals of affiliated investment advisory firms who are best positioned to provide the expertise required to manage a particular strategy or product. In keeping with applicable regulatory guidance, each such affiliate entered into a Memorandum of Understanding ("MOU") with AIA pursuant to which such affiliate is considered a "Participating Affiliate" of AIA as that term is used in relief granted by the staff of the Securities and Exchange Commission allowing US registered investment advisers to use portfolio management and trading resources of advisory affiliates subject to the supervision of a registered adviser. Investment professionals from AIA's Participating Affiliates render portfolio management, research or trading services to clients of AIA. Investment professionals from the Participating Affiliate also render substantially similar portfolio management research or trading services to clients of advisory affiliates which may result in performance better or worse than presented herein. This means that the employees of the Participating Affiliate who are involved in the management of strategies and other products offered to US investors are supervised by AIA.

AIA's Form ADV Part 2A, which provides background information about the firm and its business practices, is available upon written request to:

Compliance Department, 225 West Wacker Drive, Suite 2250, Chicago, IL 60606

CONTACT US

If you have an enquiry, in the first instance please contact:

ANITA SKIPPER,
Senior Analyst, Corporate Governance
Tel: +44 (0)20 7 809 8205
Email: anita.skipper@avivainvestors.com

Alternatively, you can visit us online at www.avivainvestors.com

CANADA

**100 King Street West,
Floor 49, Toronto, Ontario,
Canada M5X 2A2
Tel: +1 416-360-2769
info.aia@avivainvestors.com**

US

**225 W. Wacker Drive
Suite 2250
Chicago, IL 60606
Tel: +1 312-873-5800
info.aia@avivainvestors.com**