The Value of Corporate Governance: The positive return of responsible business

Now more than ever

The world is now amidst the greatest crisis of confidence in business and market capitalism since the 1929 Wall Street crash. This is compounding the economic downturn that had already started. The current financial situation will result in significant business and broader social challenges. These short-term pressures must be addressed in a responsible way, endeavouring to minimise the damage to long-term business value. In the medium to long-term, business’ and wider society’s focus will rightly shift to determine how we minimise the risk of similar corporate, regulatory and market failures in future.

The causes of the crisis are multifaceted but we believe they highlight the importance of responsible business principles as a way to strengthen and, in the banking sector, rebuild trusting relationships.

This report gathers together strong evidence to demonstrate that responsible management of environmental and social issues and their governance does create a business ethos and environment that delivers improved financial performance.

This is based on research conducted with Ipsos MORI, which examines the financial performance of FTSE companies which have measured and managed their corporate responsibility through Business in the Community’s Corporate Responsibility Index (CR Index) in each of its six years, and compares their financial performance with that of the FTSE 350 and FTSE All-Share.

In addition we compared SRI indexes and their benchmarks as well as drawing on the performance of a number of companies performing well on ESG (environmental, social & governance) issues against their mainstream benchmark.

In many respects good corporate governance is the glue that underpins responsible business practice, which ensures positive workplace management, marketplace responsibility, environmental stewardship, community engagement and sustained financial performance. As recent events remind us, ignore one or more of these areas and there is likely to be an impact on overall performance and competitive advantage.

At Business in the Community we believe responsible business is just good business. This evidence shows that good businesses are profitable businesses.

Stephen Howard, Chief Executive, Business in the Community
Corporate Responsibility Index and Financial Performance

Business in the Community has for many years stated that responsible business is just good business and reflects enlightened self interest. To test this assertion we commissioned Ipsos MORI to conduct statistical analysis using the financial data for a group of 33 companies who have participated in the Business in the Community CR Index each year 2002-2007 and are listed on the London Stock Exchange. The objective of the analysis was to look for a correlation between the extent to which these companies’ corporate responsibility performance (as measured by their Corporate Responsibility Index scores) and their financial performance (looking at three measures: total shareholder return, dividend yield and stock price returns volatility) may be linked.

The performance of this group of 33 companies was also compared to both that of the FTSE All-Share and FTSE 350 groups.

The companies included in the analysis are:
- 3i Group
- AMEC
- Anglo American
- Barclays
- BBA Aviation
- BHP Billiton
- BT Group
- Cadbury Schweppes
- Carillion
- Diageo
- Friends Provident
- Go-Ahead Group
- HBOS
- International Power
- ITV
- J Sainsbury
- Lloyds TSB
- Marks & Spencer
- National Grid
- Northumbrian Water Group
- Pearson
- Reckitt Benckiser
- Reed Elsevier
- Rentokil Initial
- Rio Tinto
- Rolls-Royce
- Serco Group
- Severn Trent
- Shire
- Tesco
- Unilever
- United Utilities
- WH Smith

Total Shareholder Return

Companies consistently participating in the CR Index outperform the FTSE 350 on total shareholder return 2002-2007 by between 3.3% and 7.7% per year

Perhaps the purest measure of shareholder value, the research examined the relationship between Total Shareholder Return (TSR) and CR Index performance. For each year 2002 to 2007 inclusive, the average TSR is calculated for both the 33 companies participating in the CR Index and the companies in the FTSE All-Share Index.

The most striking finding is that in all six years, the CR Index companies outperformed both the All-Share and 350 groups. 2003 saw the smallest difference between the groups, with the CR Index companies outperforming All-Share companies by 2.8%, and the FTSE 350 by 3.3%. This difference was largest in 2004, outperforming both the FTSE All-Share and the FTSE 350 by 7.7%.

How significant are these findings? To generalise this across all potential companies of good governance and responsibility, significance testing (Student’s T-test) was employed, assuming equal variance between the two groups. At the standard 5% significance level, companies with good governance have significantly higher TSR than all companies in 2004 and 2006. Relaxing the significance level to 10%, this difference is also found in 2005.
No statistically significant consistent correlation was found between dividend yield and CR Index performance.

The same analysis was conducted using average dividend yield for the 33 companies as a key indicator. While this is a key financial measure, it should be borne in mind that this is affected by other corporate activity and decided by the Executive team. The analysis showed there is evidence that the companies which benchmarked through the CR Index outperformed the FTSE All-Share and the FTSE 350 by dividend yield in five of the six years measured. Only the data for 2003 stand up to significance testing at the 5% level. Therefore, we are not able to say conclusively that there is a proven relationship.

The better a company measures its environmental and social impacts, the less volatile it is.

A Pearson Product Moment Correlation Coefficient was calculated between the average 12 month volatility and the average CR Index on the 33 participating in the CR Index. For both measures, the average was calculated from six end-of-year time points between 2002 and 2007. The resulting correlation coefficient was -0.387 (significant at the 95% significance level), showing that higher levels of performance in the management and integration of environmental and social issues and associated governance factors, as measured in the CR Index, are associated with lower levels of stock price returns volatility.

Just as importantly, the research also demonstrated the higher the company scored on the CR Index, and therefore the better the company managed its environmental and social impacts, the less volatile the stock price returns.

We also looked at other indicators which might affect stability and financial performance, such as length of Chief Executive tenure. In this particular analysis where we grouped the 33 companies according to the number of Chief Executives in the six year time period, there was no statistically reliable evidence that this impacted on the performance of the CR Index or on 12 month stock price volatility.

LGIM supports the work done by BITC in developing the CR Index and we see it as a positive force for company development. We have consistently believed strong performance on governance issues matters to the overall success of a company. As such we welcome the new BITC research.

Peter Chambers, CEO,
Legal & General Investment Management
Responsible business: a measure of success?

In addition, Business in the Community examined a number of studies that explored the link between Environmental Social & Governance (ESG) factors and financial performance. While there are certain limitations, not least because of the relatively short time period of data available and the inherent difficulties in establishing causal links, the vast majority of research appears to support a positive correlation between sound ESG management and better financial performance.

For example, the Dow Jones Sustainability Index (DJSI) 2008 report, affirmed a “positive strategically significant correlation between corporate sustainability and financial performance”, citing that a number of its indexes have outperformed their comparative benchmarks in relation to total returns since the launch of the respective indices². In particular, the report found that sustainability strategies had a significant impact on “the cost of external financing, return on invested capital, sales growth and the fade-rate of a firm’s competitive advantage”.

And we found a number of SRI indices showing outperformance compared to its benchmark.

For example:
• The KLD Domini 400 Social Index which between May 1990 and June 2004 returned US$5.40 for each dollar invested compared to $4.60 returned by the S&P 500³.
• The Bovespa ISE Index, one of the first sustainability indices to be launched in Brazil in December 2005 has given returns of 26% to its investors compared to the 18% returns of the IBBrX50, the benchmark index of Brazil.

We also found a number of other studies which have sought to create groups of strong ESG performers and compare them to a relevant benchmark.

In particular, these four studies stand out:
• The GS Sustain list of companies created by Goldman Sachs using their ESG framework identified 44 companies who have outperformed the MSCI WorldE by 25% since August 2005, and 72% of whom have outperformed their peers over the same period⁴.

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<td>Myners Review of Institutional Investment advocates shareholder activism</td>
<td>FTSE4Good launched</td>
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<td>All-Party Parliamentary Corporate Governance Group established</td>
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• Sustainable Asset Management (SAM) and the UN Global Compact compared the performance of the 76 Global Compact signatories listed in the DJSI World Index (named the GCS76) and compared their performance to the mainstream MSCI World over a three year period. The study found that in a declining market, this group of 76 outperformed the mainstream MSCI World by 3.7% over the three-year period between June 2001 and June 2004.

• SolAbility claims to have achieved a staggering 200% outperformance over five years from 2002-2007 between their 50 top-rated sustainable Korean companies in comparison to the KOSPI benchmark.

• In Australia, AMP Capital Investors found that companies with a high corporate responsibility rating outperformed the ASX200 by 3% over four and ten year periods, and that this trend was evident even in a difficult market.

Investment decisions and policies play a major part in creating the world in which we live today and in the years ahead.

Sir Derek Higgs

Work in Progress

Despite this evidence and an increased interest in social and environmental factors, there remains a communication challenge for responsible companies and the investment community about ESG management’s financial value.

Even before the impact of the financial crisis had hit, earlier this year the World Economic Forum reported that 70% of fund managers still do not regard it as standard practice to factor environmental, social, and corporate governance initiatives into their investment decisions. Alyson Warhurst, at Warwick Business School, believes that fund managers have not been paying as much attention to ESG as they do risk management, and therefore risk losing the ability to perceive long-term challenges facing their investments and the potential through ESG focus to drive greater returns.

There remains an opportunity for investors and companies to work together to ensure that good corporate governance and responsibility is just the way we do business. As the market re-emerges from its current crisis, is this the time when the responsible economy comes of age?
Principles for good governance of corporate responsibility

Business in the Community urges all our members and the wider business community to implement our eight principles for good governance of corporate responsibility and those that believe they have already done so, to review their governance arrangements regularly. These principles are based on those originally set out in Rewarding Virtue - Effective Board Action on Corporate Responsibility\(^8\). These are:

1. Provide leadership and commitment to set responsible business values and standards;
2. Think strategically about corporate responsibility;
3. Request regular information on implementation against targets;
4. Engage in improving regulation in your business sector;
5. Align performance management to reward responsible success over the long term;
6. Create a culture of integrity;
7. Use internal audits and risk management to secure responsibility; and
8. Regularly review their governance arrangements.

Previous research earlier this year, conducted with the Doughty Centre, demonstrates that corporate oversight of environmental and social impacts makes a difference. The findings from the CR Index analysis demonstrated that companies with corporate responsibility committees reporting to the board increased from 13% in 2002 to 60% in 2007. The research also showed that those companies with a focused board sub-committee are more likely to better manage their social and environmental impacts - performing higher across the overall CR Index.

Good corporate governance is essential for a company aspiring to be a responsible business. It is increasingly recognised that this includes effective governance and oversight of a company's commitment to corporate responsibility and sustainability.

Professor David Grayson CBE
Director, Cranfield School of Management

Notes

1. TSR is calculated for the stated calendar year and represents the net change in share value plus the total dividends per share as a percentage of its start-of-year share value. Please note that the performance figures are unadjusted returns, and do not take account of risk or industry sector.

2. ‘DJSI Annual Review’, September 2008, a cooperation of Dow Jones Indexes, STOXX Ltd. and SAM


5. SolAbility Sustainability Assessment Tool
http://www.solability.com/eng/SRI/Performance.htm


7. “Investors Still Don’t Get Accountability” (Business Week, 26 February 2008), Alyson Warhurst, chair of Strategy and International Development at Britain’s Warwick Business School, highlighted a survey of 40 institutional investors conducted by on behalf of transportation company TNT and the World Economic Forum.

8. Rewarding Virtue: Business in the Community, FTSE Group and Insight Investment, 2005
**Additional sources**


‘Sustainable and Responsible Performance’, Wim Vermeir, Eveline Van De Velde, and Filip Corten, Euromoney Institutional Investor Fall, 2005


‘The Sustainability Yearbook 2008’, SAM & PwC


‘Responsible investment doesn’t hurt returns’, UNEP & Mercer, Australia, 24 October 2007 http://www.mercer.com/pressrelease/detailshtm?idContent=1285815


‘DJSI Annual Review’, September 2008, a cooperation of Dow Jones Indexes, STOXX Ltd. and SAM

‘Corporate Responsibility and the Financial Crisis’: Business in the Community’s response, October 2008

**Glossary**

**A**

Cr Index: Established in 2002, and managed by Business in the Community, it is the UK’s leading self-assessed corporate responsibility benchmark, giving companies a framework to measure and compare their corporate responsibility management with peers.

**B**

Total Shareholder Return: The total return earned on a share over a period of time: dividend per share plus capital gain divided by initial share price.

**C**

Dividend Yield: Gross dividend per ordinary share (including both interim and final payments) divided by current share price.

**D**

Stock Price Volatility: Average 12 month volatility figure for stock price return

**E**

MSCI World: The MSCI World is a stock market index of ‘world’ stocks, The index includes securities from 23 countries, and has been calculated since 1969. It is maintained by MSCI, formerly Morgan Stanley Capital International. It is therefore a useful, and commonly used benchmark for ‘world’ or ‘global’ stock funds.
Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The aim is to align as nearly as possible the interests of individuals, corporations and society.

Sir Adrian Cadbury

We would like to acknowledge the leadership of the late Sir Derek Higgs, the corporate governance advocate, former Chairman of Alliance & Leicester and SG Warburg, and Board member of Business in the Community 1999-2006. Having chaired Business in the Environment and worked hard to raise the bar of the environmental index, he then helped develop and champion the Corporate Responsibility Index.

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For more details of the research and methodology, please visit: www.bitc.org.uk/financialimpact