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Rewarding the sustainable approach

Study shows long-term winners practice good governance

Having misreported profits by £250 million (22 Sep) FTSE 100 supermarket operator **Tesco (TSCO)** is the latest company to illustrate the damage poor governance can do to a share price. New research demonstrates a clear link between sustainability and operational and stock market performance.

The report, *From the Stockholder to the Stakeholder*, is co-authored by Oxford University's Smith School of Enterprise and the Environment and Arabesque Asset Management and draws upon analysis of 190 previous studies. The findings suggest companies which score highly on sustainability perform better, are less risky, have a lower cost of debt and equity and prove better long-term investments.

• 90% of the studies on the cost of capital show that sound sustainability standards lower the cost of capital for companies.

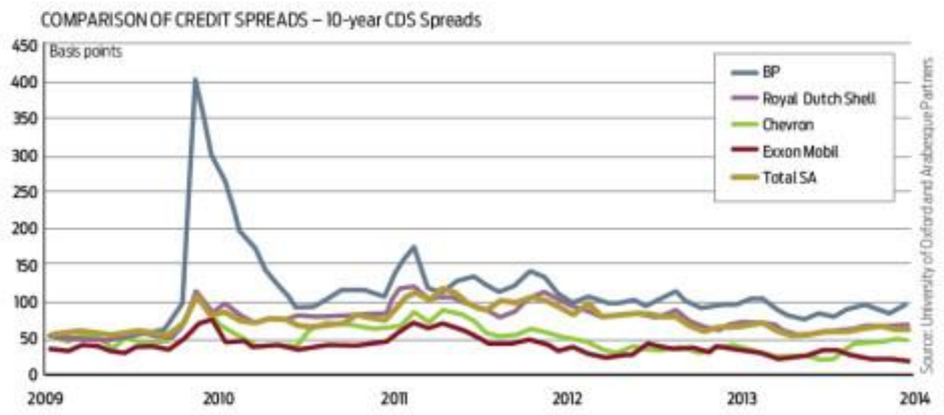
• 88% of the research shows robust environmental, social and governance (ESG) practices result in better operational performance.

• 80% of the studies show good share price performance is positively influence by good sustainability practices.

Using the example of **BP (BP.)** and the 2010 Deepwater Horizon disaster, Gulf of Mexico oil spill and subsequent collapse in its share price, the authors note: 'Astute ESG investors would have avoided investing in BP at the time of the oil spill. Notably, two years before the spill happened there was severe criticism of the company's performance in environmental pollution, occupational health and safety issues, negative impacts on local communities and labour issues, according to (business intelligence specialist) RepRisk.

'Additionally, MSCI excluded BP (in 2005) from their sustainable equity indices after the Texas City explosion and a perceived lack of action from BP on health and safety issues.'

(Click on chart to enlarge)



The chart shows that spreads on BP's credit default swaps (a form of insurance against non-payment of debt) spiked in the immediate aftermath of the disaster and are still much higher than those of its immediate peers.

Clearly better governance and a sustainable business strategy needs to start at the top and Legal & General Investment Management's corporate governance director Sacha Sadan says scrutiny of boards needs to be tightened up. 'Behind every successful company is an effective board. It's a message we've been spreading for many years which is why we welcomed the Financial Reporting Council's decision to officially require FTSE 350 boards to be externally reviewed every three years.

'Used correctly, reviewers can bring a fresh pair of eyes and experience to solve common company problems. However, four years after these reviews were brought in, there are still big variances in the process – namely wide variation in the ways that reviewers work and how companies share the results with shareholders.'