WHITE PAPER

FEBRUARY 2015

ESG INTEGRATION IN CORPORATE FIXED INCOME

KEY TAKEAWAYS

- We have found that ESG integration enhances our efforts to mitigate and appropriately price risk, and can help us achieve our goals of preserving capital, building sustainable sources of income and seeking to opportunistically improve total return.
- The advantages of ESG analysis also include its low positive correlation with credit agency ratings and alignment with the growing importance of ESG management and sustainability in corporate strategy.
- Our credit and ESG research is enhanced through engagement calls with our corporate borrowers. Breckinridge believes that engagement leverages our voice as a stakeholder to bring greater focus on management's stewardship of investor capital.
- A company that works to manage its material ESG risks and create value for all its stakeholders may be a more stable credit and a better investment for our clients.

INTRODUCTION

Breckinridge's primary goal as a separate-account, high-grade fixed-income manager is to preserve capital, build a reliable source of income and opportunistically improve total return for our clients. As a result, we pay particular attention to mitigating credit risk. With this objective in mind, we made the decision in 2011 to integrate an analysis of environmental, social and governance (ESG) issues into our fundamental credit-research process. We have found that taking an integrated approach to investment research provides a more comprehensive and forward-looking evaluation of a borrower's ability to repay. In addition, ESG integration helps us to better identify and appropriately price risk, a key factor in investment valuation.

This commentary on the value of ESG in corporate-credit analysis provides an update to our previous white papers including *The Investment Merits of Sustainability in Fixed Income*, published in February 2013, and Breckinridge's *Corporate Credit Principles: A Sustainable Approach*, published in September 2011. 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.

WHAT IS ESG?

Environmental, social and governance (ESG) issues represent risks and opportunities that can be assessed in the context of corporate behavior and performance. They are non-financial in nature and typically affect a company's performance over the medium to long term.[1]

ESG issues are analyzed by evaluating numerous related key indicators or metrics. For example, the methodology used by Sustainalytics to evaluate the ESG performance of a company draws from a universe of more than 100 indicators with 70 to 90 indicators used for a given industry peer group.[2] A sample of ESG issues and an underlying indicator that can be used to evaluate these potential credit risks is provided in Table 1.

TABLE 1: EXAMPLE OF ESG ISSUES AND INDICATORS

Environmental Issue	Indicator
Toxic emissions and waste	Percentage of waste diverted from landfills
Water management in manufacturing	Total water withdrawn, percentage recycled
Social Issue	**Indicator**
Product safety and quality	Number, frequency or cost of product recalls
Labor management	Employee satisfaction and turnover
Governance Issue	**Indicator**
Board structure and independence	Percentage of independent directors
Business ethics and competitive behavior	Amount of fines due to anti-competitive practices

Source: Sustainability Accounting Standards Board, MSCI, Breckinridge.

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ESG-research providers like Sustainalytics have long sourced company-specific ESG information from news articles and reports from governmental agencies and nonprofits. Over the last few years, however, there has been a significant increase in ESG reporting by companies as a response, in part, to requests for greater transparency from various stakeholders. According to the Governance & Accountability Institute, 72 percent of the companies in the S&P 500 produced a form of sustainability, responsibility or citizenship report in 2013, up significantly from 20 percent in 2011.[3] KPMG also saw greater adoption of ESG reporting in its annual survey: 71 percent of the 4,100 companies queried in 2013 published a sustainability report compared to 64 percent in 2011.[4]

In addition to outside pressure, a growing number of companies are pursuing sustainability initiatives, and reporting on these activities, because management believes in their value to corporate strategy. In McKinsey & Company's 2014 global online sustainability survey of corporate executives, 43 percent said "their companies seek to align sustainability with their overall business goals, mission or values", as compared to 21 percent in 2010.[5] Further, 63 percent of CEOs surveyed by the UN Global Compact and Accenture in their 2013 study on sustainability said "they expect sustainability to transform their industry within five years." [6] Finally, companies are collaborating with the recently formed Sustainability Accounting Standards Board (SASB) in the development of material, sector-specific ESG reporting standards.

ESG Risks & Opportunities

There have been notable periods when insufficient management of ESG risks had significant negative consequences for companies and their investors. The technology and telecom meltdown (2001-2002), when corporate governance failures were rampant, resulted in massive losses of both stockholder and bondholder value.[7] During the U.S. financial crisis (2007-2008), bondholders experienced extraordinary losses on investments in brokerage houses due to inadequate oversight of the risks inherent in their financial products and investments.[8] More

"ESG integration helps us to better identify and appropriately price risk, a key factor in investment valuation."

recently, environmental (2011) and mortgage litigation (2013-2014) costs have materially impacted issuers in the energy and banking sectors, respectively.[9] [10]

There also is evidence that effective ESG risk management pays off. A June 2014 academic study found that companies who engage in corporate social responsibility activities reduce systematic risk and increase firm value.[11] A 2010 academic study showed that corporate issuers with proactive environmental practices have a lower cost of debt, which typically correlates with stronger creditworthiness.[12]

Quantifying the positive effects of sustainability initiatives on financial returns can be challenging for companies. Nevertheless, cost savings from energy, waste and water efficiency are real, can be quantified and can drive margin expansion. Of the 25 companies we spoke to during our summer engagement project, only one, Praxair Corporation, has been able to calculate the total dollars saved through their sustainability projects. Praxair developed its Sustainable Development Management System to gather environmental and social information about its business. Using this system, Praxair has shown that its sustainability productivity improvements yield real savings: $112 million in 2012 and $500 million in total.[13]

Moreover, an understanding of ESG can help a company identify revenue-enhancing opportunities, such as new product offerings that help customers become more sustainable. For example, The Home Depot Inc. offers more than 7,700 Eco Option products, such as LED light bulbs and tankless water heaters. In addition to saving customers money through lower utility bills, these products generated 7.5 percent of total sales for the company in 2011 and are growing more quickly than the rest of the business.[14] Clearly ESG management also presents opportunities for companies.

WHY WE INTEGRATE ESG

Breckinridge employs a bottom-up credit-research approach to investing in corporate bonds. This emphasis on fundamental analysis supports our primary investment mandate of preserving capital, building sustainable sources of income and seeking to opportunistically improve total return. As a result, our credit analysts are particularly sensitive to the goal of mitigating credit risk. Our process begins with an assessment of a company's capital sources and operating trends. Our review of capital sources focuses on an assessment of key leverage and liquidity metrics, as they are among the most important indicators of default probability and credit health. Our review of operating trends hones in primarily on margins and an in-depth free cash flow analysis. We also assess the strength of a company's business profile, market position, brand and reputation. We summarize our analyses in an internal credit rating that is assigned to each corporate credit by our analysts.

Risk Mitigation & Lower Earnings Volatility

Our emphasis on risk mitigation coupled with a long-standing commitment to fundamental credit research made the decision to integrate ESG into our investment process a natural one for Breckinridge.

Our decision to move forward with ESG integration in 2011 was also driven by the evolution in corporate sustainability reporting. Because it was available, we thought it was our duty as investors to find a way to evaluate material ESG information on our corporate borrowers, and we would be remiss to ignore it. By evaluating this broader array of risks, we determined that our analysts would be better positioned to evaluate a company's creditworthiness. Since then, we have seen how the integration of material ESG factors into our research process provides us with a more complete understanding of our borrowers, including the quality and character of management. A company's environmental footprint, its policies and risk management approach are shaped by its senior executive team. Similarly, supply chain and labor relations are social issues that are within the scope of management's responsibility. Finally, composition of the board and its subcommittees reflect management's priorities and the values embedded in the corporate culture.

In Table 2 below, we review three examples of companies with both solid fundamental credit and environmental, social and governance characteristics.

TABLE 2: EXAMPLE OF COMPANIES WITH SOLID CREDIT AND ESG CHARACTERISTICS

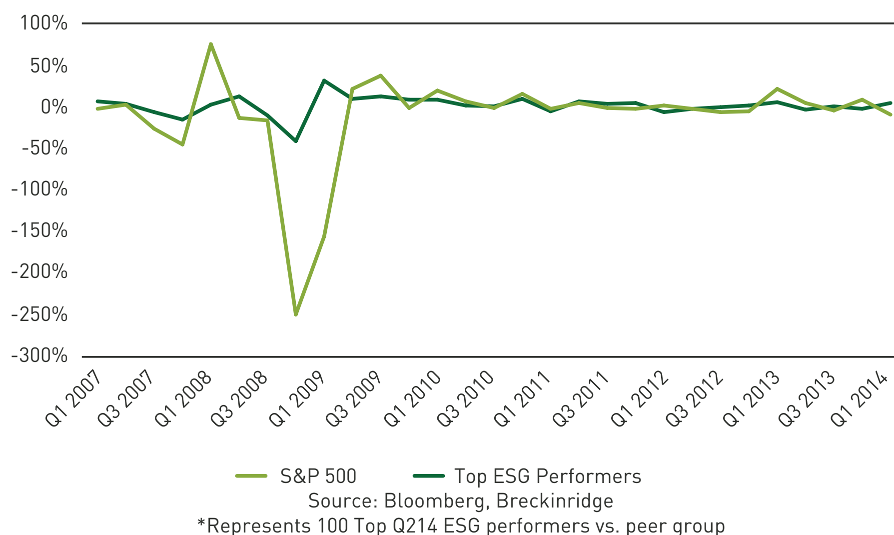
E	Risks stemming from the impact of management's operational decisions on the environment. A company with operations that rely on natural resources is better placed to safeguard its reputation, reduce future costs and avoid a ratings downgrade by remaining committed to environmental protection in both word and action.
	Statoil ASA, is a Norwegian integrated oil and gas company. From a credit perspective, Statoil's financial leverage is among the lowest in the integrated peer group. Its net debt to total capitalization ratio of 10 percent and net debt to earnings before interest, taxes, depreciation and amortization (EBITDA) ratio of 0.2 times provide significant flexibility. Its liquidity is also strong with $18 billion in cash and short-term investments at its most recent quarter-end. Environmentally, Statoil is an industry leader in carbon intensity, spill prevention, emissions and environmental safety. It demonstrates a strong track record in developing alternative technologies, particularly offshore wind energy generation.
S	Risks derived from a company's relationships with employees, customers, suppliers and the community. Management who carefully weigh the costs and benefits associated with these relationships can help mitigate controversy risks.
	BHP Billiton Plc (BHP) is the largest mining company in the world. Through commodity price cycles, it has demonstrated a consistent ability to maintain strong free cash flow and moderate financial leverage. Trailing 12-month free cash flow after capital expenditures was a sizeable $8.4 billion and net debt to EBITDA was a moderate 0.9 times at its most recent quarter-end. BHP has also been actively managing its material social risks and opportunities. BHP health and safety practices are industry-leading with its total recordable injury rates at a record low in 2014. Although the company has been involved in labor controversies, it is recognized for its strong human rights policy, and comprehensive community development and engagement programs.
G	Risks that originate from a company's corporate governance policies and procedures. Corporations with effective and independent board leadership promote transparency and institute guidelines and incentives to align managerial behavior with the interests of stakeholders.
	Toronto-Dominion Bank (TD) is the second-largest depository institution in Canada, and is active in wealth management, insurance and capital markets. TD's solid profitability and steady asset quality are key credit strengths. For instance, it reported a 15 percent return on equity in the most recent quarter and credit losses are near a five-year low at 0.31 percent. We view TD as outlier versus its banking peers in managing its material governance and reputational risks and opportunities. TD has a strong governance structure with a diverse, independent board and a corporate-governance committee that oversees sustainability issues. The chairman and CEO position are split and five women sit on its 15-member board. The bank's risk management framework is considered strong.

Source: Breckinridge, Company Reports

"There has been a significant increase in ESG reporting by companies as a response, in part, to requests for greater transparency."

To better understand how ESG integration may add value from a risk mitigation perspective, we compared the net income volatility of two groups: 1) 100 companies that received our top ESG ratings and are constituents of the S&P 500, and 2) the companies that make up the S&P 500 (Chart 1 on the following page). We found that our subset of higher-rated ESG corporate credits had less variability in their earnings than the broader S&P 500 universe. Earnings and margin stability are key credit fundamentals that we monitor when managing investment-grade bond portfolios, so we believe this observed relationship is important.[15]

CHART 1: HIGH ESG PERFORMERS EXHIBIT LOWER EARNINGS VOLATILITY



Source: Bloomberg, Breckinridge
*Represents 100 Top Q214 ESG performers vs. peer group

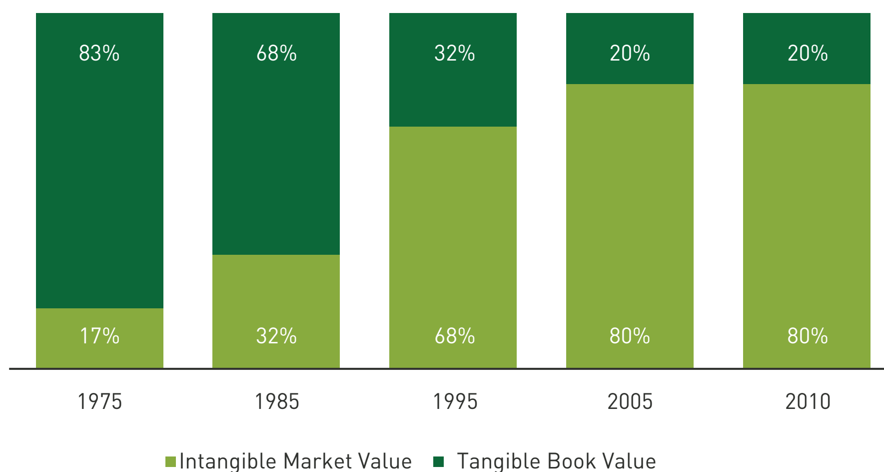
Furthermore, a 2012 meta-study by Deutsche Bank Climate Change Advisors concluded that relevant academic studies are virtually unanimous in their support of the notion that companies that have strong ESG ratings relative to peers have a lower weighted-average cost of capital. Benefits accrue to companies with the lowest cost of capital, as they are well positioned to invest in their businesses and generate sustainable returns above their weighted-average cost of capital.[16]

An Intangibles Economy

ESG analysis is also useful when evaluating a company's stewardship of its intangible assets. The International Accounting Standards Board defines an intangible asset as an "identifiable non-monetary asset without physical substance".[17] Examples of intangible assets include trademarks, patented technology and computer software. The value of certain intangible assets, such as goodwill, is accounted for on a balance sheet. For others, like customer lists and supplier relationships, it can be argued that their value is captured in a company's equity market capitalization.

In 2010, 80 percent of the S&P 500's equity market valuation was based on intangible assets, up from 17 percent in 1975, as shown in Chart 2.[18] The starting point in 1975 reflects a U.S. economy more heavily concentrated in manufacturing, when valuations were largely based on hard assets like equipment and facilities. Today, our economy is knowledge-driven and consumer-driven with investors placing a greater premium on intellectual capital and patents.

CHART 2: S&P MARKET VALUE SHIFTED TOWARDS INTANGIBLE ASSETS



Source: Ocean Tomo, LLC Annual Study of Intangible Asset Market Value

Traditional accounting is an effective tool for tracking key financial figures such as revenue and earnings. But it falls short in its ability to report on non-financial risks that may affect a company's reputation with its customers or the communities in which it operates.[19] ESG integration plays an important role in the analysis of non-financial risks and opportunities. A company that has poor understanding or oversight of its ESG risks leaves itself susceptible to a situation that could tarnish its brand and competitive position. Ultimately, and in some cases immediately, this may lead to a loss in equity market valuation and, most concerning to Breckinridge, affect the present and future performance of its bonds.

Additive with a Low Correlation to Moody's Ratings

MSCI found a low positive correlation between its ESG ratings and Moody's credit ratings in its study of this relationship in October 2012 (Table 3). In the analysis, MSCI calculated a correlation of 0.34 between their ESG ratings and Moody's ratings of comparable corporate issuers.[20] This finding suggests that the ESG factors we consider material in our evaluation of a credit may not be fully considered by Moody's.

Rating agencies typically have a horizon on their corporate ratings of 12 to 18 months. While some ESG risks, such as governance issues, may be relevant in that time frame, agencies may not consider other longer time horizon risks.[21] Since we will regularly invest in bonds with 5- and 10-year maturities, a broader assessment

of risk, including ESG, is imperative. Although the management of certain ESG issues may not have a material impact on the credit profile of the company over the short-term, these risks may linger and affect the company's ability to repay its debt over longer periods of time. Therefore, our longer-term investment perspective coupled with the low positive correlation between ESG and credit ratings supports our belief that ESG analysis offers additional informational value.

TABLE 3: ESG RATINGS PROVIDE ADDED INFORMATION VALUE

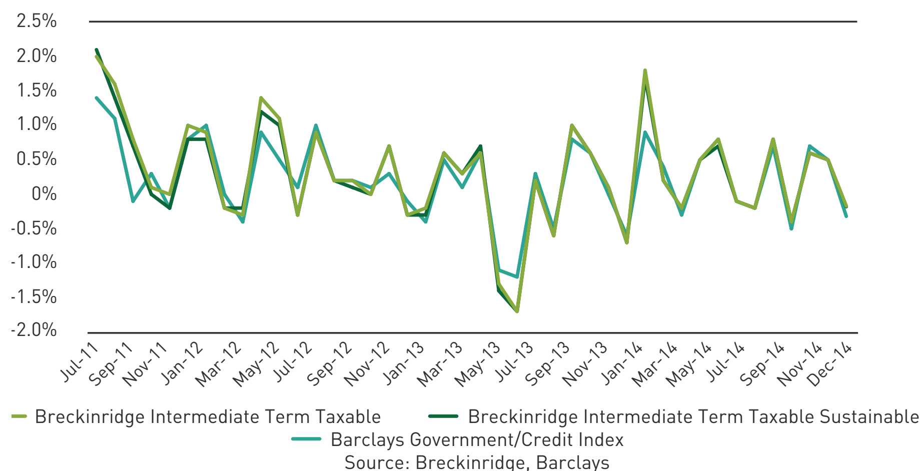
Corporates	Correlation
All Sectors	**0.34**
Industrial	0.10
Financial	0.22
Utility	0.30

Source: MSCI Ratings Analysis as of October 2012.

Comparable Returns; Potentially Lower Volatility

We expect the returns and volatility of ESG fixed-income strategies would at a minimum be comparable to traditional fixed-income strategies in the near term and have the potential to outperform over the long term. While truly long-term performance data is lacking, our experience at Breckinridge over a three-year period and the findings of an MSCI analysis over seven years demonstrate that an investment in ESG fixed-income strategies delivers comparable returns to an investment in traditional fixed-income strategies with potentially lower volatility. The returns and standard deviation of the Breckinridge Intermediate Term Taxable strategy are consistent with the same measures for the comparable Breckinridge Intermediate Term Taxable Sustainable strategy. For the first eight months after its launch in July 2011, there was a modest difference in returns, as can be seen below in Chart 3.

CHART 3: A HISTORICAL COMPARISON OF MONTHLY GROSS TOTAL RETURNS



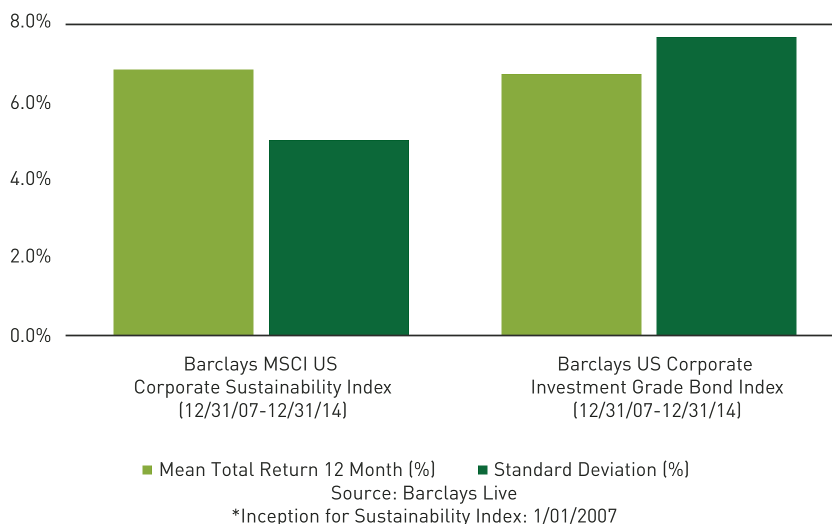
Source: Breckinridge, Barclays

This was attributed to the smaller size of the Taxable Sustainable composite, which made it more sensitive to trading activity and bond maturities, among other factors. As the number of accounts in the composite has grown, returns between the two strategies have converged.

The convergence is also evident when year-to-date returns through November 2014 are compared to annualized returns since inception of the Taxable Sustainable Strategy. Furthermore, volatility, as measured by the standard deviation of returns is comparable from July 2011 through November 2014.

Additionally, in 2013 Barclays and MSCI introduced a new group of fixed-income indices that incorporate ESG ratings from MSCI. These new indices share the same eligibility standards as the Barclays fixed-income indices, such as the minimum debt issue size of $250 million and investment-grade issuers only. MSCI looked at back-tested returns for the Barclays MSCI U.S. Corporate Bond Sustainability Index, which includes "Best-in-Class" ESG corporate issuers. Barclays and MSCI have found that total returns were comparable and volatility measures were slightly better for the Barclays MSCI ESG U.S. Corporate Bond Sustainability Index versus the relevant Barclays U.S. Corporate Bond IG Index since the inception of the Barclays MSCI ESG indices in January 2007 (Chart 4).[22]

CHART 4: BARCLAYS MSCI COMPARISON OF TOTAL RETURNS AND STANDARD DEVIATION



Source: Barclays Live
*Inception for Sustainability Index: 1/01/2007

Know Your Borrower

We believe that ESG integration offers a more comprehensive assessment of our borrowers. In Figure 1 on the following page, we illustrate how the management of material ESG issues can affect, either positively or negatively, a company's operating and financial performance.

FIGURE 1: AN EXAMPLE: A HYPOTHETICAL BEVERAGE COMPANY AND ITS ESG RISKS AND OPPORTUNITIES

	Supply Chain (Upstream)	Company Operations (Manufacturing)	Use and Disposal (Downstream)
E	Development and use of an extensive water management plan can help the company manage through periods of water scarcity, a business risk that can lead to reduced crop yields, higher input costs and lower profits.	Lack of clear goals and timetables to cut or eliminate waste and emissions from production facilities demonstrates a missed opportunity to benefit from efficiency projects that can reduce operating expenses and boost profits.	Efforts to reducing packaging materials and post-consumer waste can benefit the company through lower shipping costs, increased awareness and support from consumers for its products.
S	Weak human rights and supplier code of conduct policies demonstrate inadequate oversight of working conditions at suppliers, which can leave the company susceptible to a controversy that damages its brand.	Comprehensive health, safety and wellness programs for employees help to reduce workplace injuries, foster morale, and increase retention and productivity.	Responding to consumer preferences for healthier products by introducing new low- or no-calorie beverage options and by reducing sodium and sugar content in existing products can boost demand and sales, and help counteract new legislation aimed at curbing soda sales.[23]
G	Strong bribery and corruption policies help govern the interaction of employees with suppliers. Evidence of a bribe, kickback or inappropriate gift can contribute to higher costs in the form of litigation, fines and increased regulation.	A board-level committee on sustainability may be indicative of a serious, corporate-wide commitment to driving accountability and innovation in the management of ESG issues.[24]	A corporate culture characterized by poor transparency including inadequate ESG reporting and spotty stakeholder engagement can cause ill will among customers and may impair the company's "license to operate."[25]

Source: Breckinridge, Corporate Sustainability Reports, KPMG,[26] MSCI, Sustainalytics

HOW WE INTEGRATE ESG

We outline in Figure 2 the process by which credit research and ESG analysis drives our investment decisions.

FIGURE 2: CREDIT WITH ESG IS USED TO ANALYZE COMPANIES FOR INVESTMENT

To integrate ESG issues into our investment process, we created a framework that aggregates ESG metrics and information from ESG-research providers as well as other third-party sources. As part of their credit research, our corporate analysts review a company's ESG policies and targets, which in many cases are outlined in its corporate sustainability report. This qualitative assessment is also an important component of our ESG framework.

FIGURE 3: EXAMPLE: CREDIT UPGRADE/DOWNGRADE FOR ESG RISKS

As seen above, the qualitative assessment, along with data and information from third parties, is weighted and scored. The score is translated into a sustainability rating. This measure of a credit's ESG risk profile may affect the analyst's internal rating on a company. The analyst can raise the internal

rating to reflect a corporation's low ESG risks, or downgrade the rating if ESG risks are considered high or poorly managed. The final internal rating may drive valuation and trading decisions (Figure 3).

Our Engagement Efforts

Our knowledge of our corporate borrowers is also enhanced through engagement calls. Breckinridge believes that engagement leverages our voice as a stakeholder to bring greater focus on management's stewardship of ESG issues, in accordance with the Principles for Responsible Investment.[27] Bondholders play a key role in the capital structure, but unlike shareowners, we have no formal venue such as proxy voting where our voice can be heard systematically. To address this, we direct our engagement efforts to private dialogues with management. During these discussions, we gain a better understanding of the credit and ESG profiles of borrowers and the material issues, opportunities and risks they face. At the same time, we proactively encourage transparent reporting on material ESG issues and the management of those risks, especially when disclosure falls below best practices.

In the summer of 2014, we had engagement calls with the 25 largest investment-grade corporate holdings in these six diverse sectors: chemicals, food and beverage, media and telecommunications, real estate investment trusts, retailers, and rail and transportation. We began the engagement process by conducting thorough ESG research on each company. We used third-party ESG sources such as MSCI and Sustainalytics, as well as publicly available documents such as corporate social responsibility reports and proxy statements. This in-depth research helped us create individualized questionnaires for each corporation on material ESG risks and opportunities.

To introduce our prepared questions in our conversations with management, we explained how we look at ESG issues as part of our credit research. Following calls, notes were recorded and archived for future use by the credit-research team. Analysts used key takeaways from the calls to modify their qualitative ESG assessments and scores for specific companies. These adjustments led, in some cases, to changes in their sustainability and internal ratings.

TRENDS IN CORPORATE SUSTAINABILITY

The summer's round of engagement highlighted three trends in corporate sustainability, one positive and two that indicate there is room for improvement (Table 4).

TABLE 4: CORPORATE SUSTAINABILITY TRENDS

+	Businesses are setting targets to reduce their environmental impacts
-	Limited board-level oversight of sustainability initiatives
-	No widespread link between executive compensation and ESG goals

Setting Environmental Targets

All of the companies we spoke with plan to reduce their environmental externalities in some way. Said another way, we heard that management teams understand that their business activity can be harmful to the environment. They demonstrate their intention to mitigate related regulatory and reputational risks by setting and working to achieve targets. We found that the most common goal among the companies we contacted is to cut greenhouse gas (GHG) emissions; 87 percent of the companies have set this as a target. Importantly, third-party ESG research cites carbon emissions as a material concern for the industries we targeted for calls.[28] Additionally, 83 percent of our sample responded to the most recent CDP survey.[29] The average CDP disclosure score, which measures transparency of the response, was a high 92.3 out of 100. The CDP global average is 56.[30] So management teams at a number of companies are identifying GHG emissions as a risk for their businesses; are reporting on it; and are working to mitigate it.

Other areas related to environmental impact include water and waste reduction goals. The materiality of these two areas, unlike GHGs, is not consistent across all sectors. For example, water is a material ESG issue for food and beverage companies, but not for the rail transportation sector. For the companies where water is deemed a material concern, 75 percent have goals to reduce their water consumption. We observed a similar trend in the area of non-hazardous and hazardous waste. Waste reduction is applicable for about one-half of the companies we surveyed. Of this group, 71 percent have goals to reduce waste.

Sustainability Oversight by the Board

In addition to company-specific questionnaires, we prepared a few questions that we asked in each of our conversations. One of these questions pertained to board-level oversight of sustainability initiatives. We asked if the company's board of directors had a standalone sustainability committee or if board members were engaged in some way with ESG issues. We found that none of the companies in our sample had a standalone sustainability committee at the board. Lynn Paine, Harvard Business School professor, mentions in her recent article that "such a committee could be a useful addition to many if not most boards" by serving as a source of knowledge and a driver of change.[31] The article also states that no more than 10 percent of U.S. public companies have a dedicated sustainability committee.[32]

Although a sustainability committee is rare, we did learn that 56 percent of the companies in our sample have board members with some responsibility for ESG governance. The Investor Responsibility Research Center Institute (IRRCI) in their recent study similarly found that 55.4 percent of the S&P 500 companies had board oversight of sustainability issues.[33] According to the IRRCI survey, oversight of environmental and social issues were usually given to the corporate governance and nominating committee.[34]

In general, we observe that the most sustainably minded companies enact ESG initiatives from the top down. As stakeholders continue to demand accountability for ESG issues and as management's understanding of these risks builds, corporate boards are likely to take on more ESG governance responsibilities.

ESG and Executive Compensation

Despite the growing interest in sustainability, few of the companies we spoke with have tied ESG performance to executive compensation. The 2014 McKinsey survey highlights as a possible culprit the conflict between short-term earnings pressure and the long-term nature of sustainability initiatives.[35] But the McKinsey survey also suggests executives are growing increasingly concerned about the disconnect between ESG and executive compensation. Of the executives who responded, 34 percent "say too few people at their companies are accountable for sustainability", a notable increase from 23 percent in 2011.[36] In their Roadmap for Sustainability, Ceres found that 39 of the 600 companies evaluated in this study—only 7 percent—formally link ESG goals to executive compensation.[37] In cases where compensation incentives are tied in some way to ESG issues among our sample of companies, the most common area was health and safety. This was typically seen in businesses with large labor forces and complex and industrialized operations, such as in the food and beverage, and rail transportation sectors.

Ceres says that investors are beginning to ask for compensation and ESG alignment, and expect this development will grow due to the compelling business case for sustainability.[38] We agree and believe that companies that add financial incentives for reaching ESG goals are more likely to be successful in fully integrating sustainability into their operations.

IN SUPPORT OF STANDARDIZED ESG DISCLOSURE

As mentioned above, company disclosure of ESG data and metrics has improved over the last several years. However, disclosures are not standardized across sectors or even within sectors and are also not integrated into regulatory filings like the SEC's 10-K report. The emergence of the Sustainable Accounting Standards Board (SASB) in 2011 represents a strong step forward as it pertains to incorporating material, sector-specific ESG factors into a corporation's regulatory filings for the benefit of investors. SASB's mission is to cultivate and circulate sustainability accounting standards that assist public corporations in disclosing material ESG information. This is undertaken through an extensive process that includes fact-based research and stakeholder participation.[39] It has a number of corporate partners. We support SASB's efforts to integrate sustainability reporting with financial reporting by serving on its Advisory Council and participating in sector specific SASB working groups.

CONCLUSION

ESG analysis has been a valuable addition to our credit-research process. It has assisted us in identifying and appropriately pricing risk. ESG issues and the evolution in corporate ESG reporting also reflect the growing appreciation that companies have many stakeholders, including customers, suppliers, bondholders and employees. In recent times, there has been a singular focus on the concerns of shareholders, or what is called shareholder value maximization. This has in many cases led to short-term thinking (e.g. excessive share buybacks) at the expense of long-term investment. James Montier at GMO, argues that strict adherence to shareholder value has hurt long-term equity performance and the growth potential of the US economy.[40] A fiduciary duty exists when a person or management has responsibility or discretion over assets of the shareowner.[41] But, considering other stakeholders in the management or board decision-making process need not negatively impact shareholders and if done skillfully, additional value may be created.

Managing varying stakeholder interests presents risks and opportunities to companies and their boards. We believe that, if managed well, a company will be better positioned to reduce its cost of capital, protect its brand and compete effectively into the future. As a result, a company that works to create value for all stakeholders may be a more stable credit and a better investment for our clients.

FOOTNOTES:

1. CFA Institute Inc., "Environmental, Social and Governance Factors at Listed Companies", a Manual for Investors, 2008
2. Sustainalytics, Sustainalytics Global Platform Manual. Version 1.0, March 2013
3. Governance & Accountability Institute, Inc. "Flash Report: 72 percent of S&P 500 Companies Now Publishing Sustainability/Responsibility Reports", June 3, 2014.
4. KPMG International, "The KPMG Survey of Corporate Responsibility Reporting 2013", pg 11
5. McKinsey and Company, "Sustainability's strategic worth: McKinsey Global Survey", 2014. This annual survey collected responses from 3,344 corporate executives from February 11 to February 21, 2014.
6. See "The UN Global Compact-Accenture CEO Study on Sustainability 2013", pg 11
7. Monks, R.A.G. & Minow, N., Corporate Governance, March 2012, pg xxi. The authors note how inadequate corporate governance practices contributed to fraud and significant stakeholder losses in 2002.
8. Larcker, D. and Tayan, B., A Real Look at Real World Corporate Governance, July 2013, pgs 20-25. The authors refer to Lehman Brothers as an example of how ineffective board oversight contributed to the brokerage firm's demise. The board lacked qualified directors as none of the members had financial services expertise, among other issues.
9. Bakhsh, Nidaa, "BP Maintains Gulf of Mexico Oil Spill Cost at $43 billion", Bloomberg Businessweek. The article mentions that a US judged determined that BP Plc "acted with gross negligence in drilling the Macondo well of the Louisiana coast" in September 2014. With this finding, BP is exposed to more than $18.0 billion in fines, in addition to the $28.0 billion post-spill clean-up costs.
10. See US Department of Justice press release, "Bank of America to Pay $16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis". The settlement is related to its mortgage origination and residential mortgage backed security and collateralized debt obligation activities.
11. Albuquerque, R., Durnev, A. & Koskinen, Y., "Corporate Social Responsibility and Firm Risk: Theory and Empirical Evidence", Boston University and University of Iowa, June 2014
12. Bauer, R. and D. Hann, "Corporate Environmental Management and Credit Risk", Maastricht University, European Centre for Corporate Engagement (ECCE), December 2010
13. The figure of $112 million in 2012 savings from sustainability productivity came up during our call with Praxair's investor relations and sustainability professionals. The cumulative $500 million in savings has been disclosed in its investor presentations: See: http://www.praxair.com/~/media/North percent20America/US/Documents/Reports percent20Papers percent20Case percent20Studies percent20and percent20Presentations/Investors/Investor percent20Presentations/2014/PraxairGoldmanSachsConferece05202014.ashx
14. From our call with investor relations at The Home Depot Inc.
15. Analysis prepared by Breckinridge Capital Advisors Inc. using data from The Bloomberg, Top 100 Q214 ESG performers vs. peer group, 2014
16. See DB Climate Change Advisors, "Sustainable Investing: Establishing Long-Term Value and Performance", June 2012
17. See Deliotte IAS Plus, IAS 38 – Intangible assets, available here http://www.iasplus.com/en/standards/ias/ias38
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28. Sustainalytics evaluated "GHG Reduction Programs" in determining overall ESG performance for all 25 companies in our sample.
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