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THE SRI CHRONICLES

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EDITORIAL

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PRI Principles for Responsible Investment

EUROPE AT A CROSSROADS

80% of climate challenges are energy related. The future will depend on the capacity of public authorities, the private sector, and citizens to collectively reduce their reliance on fossil energies, which currently make uparound 80% of the global energy mix. This percentage has only dropped by a few percentage points over the past 30 years.

The current crisis has been a catalyst, revealing Europe's dependence on fossil fuels. At the heart of the ongoing conflict in Ukraine lies the short to mid-term suspension of our purchases of natural gas and oil from Russia. The alternatives available in the near term are unsatisfactory from an environmental perspective, as they involve an increased use of coal and a surge in imports of American liquified natural gas (LNG), often produced from hydraulic fracturing. Improving energy efficiency will be the first urgent priority.

'Abstinence' is not a dirty word: the cheapest and greenest energy is simply the energy we don't use – for the planet, and for household, corporate and government budgets.

Looking forward (2030), the Ukrainian conflict may act as a lasting catalyst that will accelerate the transformation of the European economy, which is needed to achieve carbon neutrality by 2050 and improve our energy independence.

The European "Fit for 55" plan aims for a 55% cut in European greenhouse gas emissions (GHG) by 2030. The plan will leverage a wide range of environmental solutions: biomethane, energy efficiency, wind farms, geothermal energy, green hydrogen, sustainable mobility, solar energy etc. Its success will require technological progress as well as changes in our behaviour, such as reducing our reliance on air transport or our consumption of red meat. As a reminder, after much debate, natural gas and civil nuclear power have remained within the European energy mix, but only to facilitate the energy transition and within a limited timeframe of 25 to 30 years.

Finally, we would like to end on this pioneering initiative led by Yvon Chouinard, who wrote that "The Earth is now Patagonia's only shareholder". As the founder of Patagonia – a frontrunner on sustainability – Mr. Chouinard decided to transfer all ownership to a foundation dedicated to protecting the environment, in agreement with his wife and two children.

NEWS

GREEN PROGRAMMES ARE FLOURISHING THROUGHOUT THE WORLD

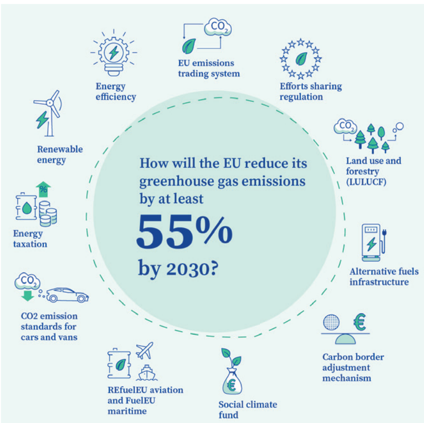
In the United States, the Inflation Reduction Act (IRA) signed on August 16th, 2022, should – among other aspects – help the US reduce its greenhouse gas emissions by 40% in 2030, compared to 2005. This is a major milestone on the road to achieving the country's objective: a 50/52% cut by 2030. The act will support investments of 369 billion dollars (364 billion euros) into energy security and climate action programmes over the next 10 years. The US has therefore deployed a green industrial policy to initiate its energy transition.

Tax credits on solar panels, wind farms, or green hydrogen will help consolidate the industries that are essential to the energy transition. The goal is also to create an American supply chain for renewable energies. For example, car owners will benefit from tax credits on electric and rechargeable hybrid vehicles assembled in North America, among other requirements.

The plan also emphasises energy efficiency and adapting to climate change.

EUROPE STEPS ON THE ACCELERATOR

In Europe, the "Fit for 55" programme took over from the European Green Deal. Its main objective is to reduce average greenhouse gas emissions by at least 55% over the next decade and gradually put an end to the European Union's economic dependence on fossil fuels. The measures mostly involve: widening (and tightening) the carbon emission quota system, creating a cross-border carbon adjustment mechanism, forestry, stricter standards on new cars etc.



Source: Council of the European Union.

With the war in Ukraine adding further urgency to the energy transition requirement, the European Union has also unveiled its "REPower EU" plan, which encourages fiscal measures fostering energy savings and will notably accelerate the deployment of renewable energies.

Both European and American plans agree on the concept of a fair transition. The IRA should enable the creation of millions of local jobs, improve the protection of poorest households, and reduce energy bills by $500/$1,000 per year. The "Fit for 55" programme suggests creating a €59 billion Social Climate Fund for 2025-2032, which will support the most vulnerable households and companies.

AMBITIOUS OBJECTIVES IN CHINA

The United States and Europe are not alone in taking action to support green investments. In December 2021, the Chinese ministry for Industry unveiled a five-year plan encouraging the environmentally-sound development of its industrial sectors, committing to cut carbon emissions, and promoting emerging industries in order to meet its pledge of capping carbon emissions by 2030. Indeed, China aims for its carbon emissions to peak by 2030 and plans to achieve carbon neutrality by 2060.

The five-year plan aims to reduce the intensity of carbon emissions (the emissions produced per unit of GDP) by 18% in five years, to lower energy intensity (the quantity of energy used per unit of GDP) by 13.5%, and to increase the share of renewables from 15% today to 20% of the energy mix. China's ambitious climate objectives will require investments worth around $19 trillion, according to the country's chief climate officer.

FROM AN ACADEMIC POINT OF VIEW

EMPLOYEE SATISFACTION AND LONG-RUN STOCK RETURNS, 1984-2020

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is a Professor of Finance at EDHEC Business School. His current research focuses on measuring intangibles and the stock market valuation of these assets. Articles based on his research have been published in leading finance, economics and management/strategy journals. Hamid's research has been widely covered in the media and financial press, including The Financial Times. Hamid is a passionate teacher and has received numerous teaching awards including the Outstanding Teacher Award in Finance and the Excellent in Teaching Award.

YOUNG DAE KANG
is a financial economist at the Bank of Korea and a consultant of the World Bank. He recently earned a PhD in Finance from the EDHEC Business School, under the guidance of Professor Hamid Boustanifar, in the study "Essays on Intangible Assets and Stock Returns" and continues his research activities. He is interested in topics such as Business Social Responsibility, Climate Finance, and Financial Stability. He has experience in the external fund management of foreign exchange reserves of the Bank of Korea, development of financial vulnerability index, and research on financial center policy of Jeonju city. His goal is to make a positive impact on society through his studies and careers.

The volume of assets that incorporates some element of socially responsible investing has grown exponentially over the past decade. Whether or not these investment strategies outperform has been a source of debate among academics and practitioners.

This paper focuses on employee satisfaction as one aspect of corporate social responsibility. Economic theory predicts that (in the absence of mispricing) the excess return to socially responsible businesses is negative in equilibrium. In sharp contrast, in an influential paper published over a decade ago, Edmans (2011) shows that a portfolio of the "100 Best Companies to Work For in America" (BCs) earns a positive and significant Carhart alpha.

This paper studies whether Edmans (2011) result (a) holds out-of-sample, (b) is driven by exposure to newly discovered factors and characteristics, and (c) depends on the state of the economy.

APPROACH

To answer these questions, the authors extend the analysis in the original study in two important dimensions: adding 11 years of more recent data and using several more sophisticated factor models to control for factors discovered since publication. Specifically, they estimate BC portfolio alpha in a sample from April 1984 to December 2020, using a state-of-the art empirical asset pricing model to examine the relationship between employee satisfaction and long-run stock return.

The dataset consists of a portfolio of 283 publicly traded companies from 1984 to 2020, composing a list of 100 "best companies" each year. The list is formed by an anonymous survey of employees by the Great Place to Work Institute, representing the largest ongoing annual workforce study in America and including over 4.1 million employees. The survey covers topics such as pay and benefits programs, employees' confidence in their organization and workplace opportunities to reach full human potential, regardless of rank and position. Company scores depend on the credibility of their communication to employees, the respect of opportunities and benefits they offer, the fairness in terms of compensation and diversity and pride they convey to their employees through teamwork, camaraderie, celebrations and philanthropy.

GENERAL FINDINGS

Edmans (2011) concludes with two distinct scenarios going forward: (1) If the market learns of the significant impact of employee satisfaction on future returns, the excess returns should disappear; or (2) "If the market does not update and arbitrage remains limited, the superior returns may persist going forward." The present paper reveals that an equally weighted portfolio of companies with the strongest employee satisfaction earns an excess return of 2% to 2.7% per year over the considered period. Consequently, its results appear to be more consistent with the second scenario.

The authors find that up to 22% of the BC portfolio's Carhart alpha could be attributed to exposures to more recently incorporated factors such as investment, profitability, and quality. However, they still estimate that the BC equal-weighted portfolio's monthly alpha ranges between a lower bound of 17 basis points (bps) and an upper bound of 23 bps during the period from 1984 to 2020. The alphas are positive and statistically significant across all factor models.

Based on the most recent empirical finance models, the BCs continue to generate sizable and significant positive excess returns more than one decade after the original publication.

EXCESS RETURNS IN DIFFERENT PERIODS

The paper further investigates whether and how these excess returns vary across periods. The estimated excess returns are positive in most periods during the sample. Importantly, BCs do not outperform only in good times. In contrast, the largest excess returns come from bad times, i.e., the crisis periods. This result is consistent with studies that provide evidence on the importance of corporate culture and corporate social responsibility in bad times such as Lins, Servaes, and Tamayo (2017), Graham et al. (2018), and Li et al. (2020). In addition, the authors do not observe any particular (upward or downward) trend in the size of the BC portfolio's alpha during the four-decade sample studied.

REASONS BEHIND OUTPERFORMANCE PERSISTENCE STILL UNCLEAR

However, more than a decade after the discovery of significant outperformance of an SRI strategy based on employee satisfaction and despite the huge rise of SRI, it is unclear why the outperformance persists. One potential reason could be that the focus of most funds and investors have been on exclusionary/negative screening rather positive or best-in-class screening. Another potential reason could be that responsible funds have been more focused on the "E" (environment) and "G" (governance) dimensions of social responsibility rather than on the "S" (social) aspect.

Furthermore, most approaches to ESG investing are predominantly based on ESG scores and easily quantifiable factors. These approaches ignore important qualitative factors such as fairness, respect, pride, and camaraderie that are used to measure employee satisfaction.

Within this context, the value of obtaining and/or constructing reliable data on employee satisfaction for a larger set of companies could be significant. More specifically, if the stock market undervalues employee satisfaction information that is publicly announced and receives huge coverage, such an undervaluation could be larger for companies that receive less attention. This, however, would require reliable employee satisfaction data on a larger set of companies. Obtaining such data is surely feasible in practice.

FURTHER STUDIES WELCOMED

The authors encourage future research to address beyond employee satisfaction the impact of other aspects of business social responsibility such as environmental protection, racism, consumers' health, gender diversity, excessive pay gaps, human rights or child labor. Second, the data of the study include only companies with the highest employee satisfaction and do not identify those that perform badly. It would therefore be interesting to analyze whether companies with low levels of employee satisfaction earn positive, negative, or no abnormal returns.

Furthermore, while the particular aspect of social responsibility (i.e., employee satisfaction) pays off for shareholders in the analyzed four-decade sample, there are surely other factors that require a trade-off between social responsibility and financial performance. Identifying those factors would be important for shareholders to form realistic expectations. It would also be useful for policymakers to design better incentives and policies to improve social outcomes when it is too costly for shareholders to invest.

Finally, the authors only investigate the effect of employee satisfaction on returns to shareholders. Studying its impact on other stakeholders, such as creditors and consumers, would be another fruitful research area.

Boustanifar, Hamid and Kang, Young Dae, Employee Satisfaction and Long-run Stock Returns, 1984-2020 (30 septembre 2021). Financial Analysts Journal, 78:3, 129-151, Disponible sur https://www.tandfonline.com/doi/abs/10.1080/0015198X.2022.2074241. Version du document de travail à SSRN : https://ssrn.com/abstract=3933687 ou http://dx.doi.org/10.2139/ssrn.3933687

COMPANY MEETINGS

TERNA

Based in Italy, Terna is a European and global leader in electricity transmission systems. The group operates Italy's national electricity transmission grid, which features almost 75,000 kilometres of high-voltage lines and 900 transformer stations scattered throughout the country, with 26 cross-border interconnections.

The company's mission is to guarantee the security, resilience, and efficiency of the Italian grid on a 24H basis and ensure that all market operators enjoy equal conditions and access to its services.

Terna is a key player in the energy transition process due to enabling full decarbonisation and the integration of renewable energy into the grid. The group's development plan for 2021-2025, called "Driving Energy", involves €10 billion investments that will help Terna accelerate its commitment to supporting the environmental transition, energy independence, and the country's carbon neutral ambitions. This will strengthen the company's key role in steering the Italian grid, in compliance with the objectives laid down in the National Energy and Climate (ENCP) Plan and the EU's "Fit for 55" package, designed to cut greenhouse gas emissions by 55% or more by 2030. In 2021, approximately 36% of the total demand for energy was met with renewable energy sources.

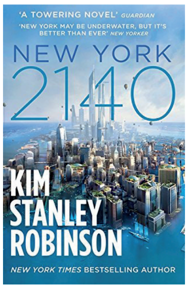
Launched at the beginning of 2021, the NexTerna programme aims to foster a cultural shift in all segments of the company and involves a strong focus on training, which is essential considering current plans for high headcount growth.

The information about the companies cannot be assimilated to an opinion of Edmond de Rothschild Asset Management (France) on the expected evolution of the securities and on the foreseeable evolution of the price of the financial instruments they issue. This information cannot be interpreted as a recommendation to buy or sell such securities.

RECOMMENDED READING

NEW YORK 2140
WHEN SCIENCE FICTION SEEMS CLOSER TO OUR REALITY THAN TO FICTION

New York 2140 is a climate fiction novel by best-selling American author Kim Stanley Robinson. Robinson, who resides in California, is a utopian and ecologically aware science fiction author who collaborates regularly with the Sierra Nevada Research Institute. After two episodes of flooding, which saw sea levels rise by a total of around 15 metres due to melting icecaps in the Antarctic and Greenland, New York turned into a "SuperVenice" at the end of the 21st century. With a great deal of wit and credibility, the novel describes the lives of residents living in a skyscraper, each with very different backgrounds - from market trader to police inspector, caretaker to chairman of the tenants' association. Recommended for all readers - not only lovers of the Big Apple.



New York 2140
by Kim Stanley Robinson

July 28th 2022

All natural resources that the planet can regenerate annually were consumed by July 28th.

Source: Global Footprint Network.

68.1%

In 2022, the global gender gap has been closed by 68.1%.

Source: World Economic Forum. NB: the global gender gap considers several metrics, covering healthcare, political empowerment, economic participation and opportunity, ability to resume work, leadership, wealth accumulation, priority given to lifelong learning, or stress levels.

INVESTOR ENGAGEMENT, FUNDAMENTAL BUT IMPERFECT

Engagement is the process through which investors leverage their position as share or bondholders to establish a long-term dialogue with companies, to influence their behaviour and encourage better environmental, social and governance policies and practices (ESG). Engagement is a more structured process than the simpler dialogue held at company meetings. It requires a formal approach, the definition of one or more objectives and indicators for measuring progress, a scheduled agenda including the possibility of partial success or failure, the planning of the decision(s) to be taken if the process fails (divestment, public statement at shareholders' meeting etc.). Engagement also involves regular communication both in-house and externally.

VERY DIFFERENT TIMEFRAMES

Engagement may cover transparency objectives – the easiest to achieve, or operational improvements, as well as strategic changes – the most challenging. The process can therefore take place over very different horizons.

Historically, engagement has mainly focused on equities, an asset class with natural ties to AGM voting policies and the submission of resolutions; however, in practice, engagement can be just as relevant in structuring relations between bond holders and issuers. Engagement may be individual, led by a single investor. It may also be a collective initiative, led by a group of investors, to boost impact and share the high costs that are involved.

INVESTORS NEED TO REDIRECT THEIR INVESTMENTS

A critical and key issue has emerged, however, concerning the effectiveness of engagement and how this is measured. While publicly, over three quarters of companies that are involved in an engagement process admit they "take into account" the requests expressed by their investors, the success rate – i.e., the strategic changes prompted by the engagement initiatives - remains low.

Engagement alone is not enough for achieving social, environmental, or governance-related impacts. Yet the challenge facing 21st century investors is to measure the impact of their investments, in addition to their financial risks and returns. As the debate on greenwashing risks continues, stakeholders (NGOs and media) are increasingly critical of investors whose approach focuses solely on engagement to drive progress on ESG matters. Investors are called upon to actively trim their investments in businesses that have been identified as carrying sustainability risks, to funnel capital into the best social and environmental solutions and the most virtuous practices.

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