



**Integration of non-financial information in investment decision making by  
institutional investors**

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## **ABSTRACT**

There has been a steady rise in demand for business to be transparent about their environmental, social and governance (ESG) performance, and their social impact in the economies they operate in. This has given rise to an emerging trend worldwide in the investor community that has been met with an increasing uptake of “sustainability reporting”. The aim of this exploratory study is to review the growing demand for non-financial information by investors and its use in the investment decision – making process of institutional investors.

Structured interviews were conducted with eight South African institutional investors and the results were analysed using a data mapping technique and content analysis.

The findings reveal a need for non-financial information amongst the investor community that is currently not being met by information that is relevant in meeting their information needs. The study identified the main ESG factors that institutional investors deem important and with it to derive a model for integrated reporting across various sectors. It also highlighted the challenges faced by the investor communities in making social responsible investing mainstream resulting in the lack of confidence in current sustainability reporting thus resulting in a lack of integration of ESG factors in the valuation model of financial analysts.

## **KEY WORDS**

Non-financial information

Investment decision making

Institutional investor

## **DECLARATION**

I declare that this thesis is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other university.

I further declare that I have obtained the necessary authorisation and consent to carry out this research.

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## **LIST OF ACRONYMS**

<b>SRI</b>	Socially Responsible Investment
<b>RI</b>	Responsible Investment
<b>ESG</b>	Economic Social and Governance
<b>IFC</b>	International Finance Corporation
<b>DFI</b>	Development Finance Institution
<b>CSM</b>	Corporate Sustainability Management
<b>GRI</b>	Global Reporting Initiative
<b>IRC</b>	Integrated Reporting Frameworks
<b>JSE</b>	Johannesburg Stock Exchange
<b>PRI</b>	Principles of Responsible Investing
<b>INCR</b>	Investor Network on Climate Risk
<b>IIRC</b>	International Integrated Reporting Council

*“Financial performance tells me what a company has already done. Non-financial performance tells me what it is likely to do.” – SAMS White Paper 2012*

# Chapter One

## 1. Introduction to the Research

### 1.1. Background

The last decade has seen a steady rise in public demand for businesses to be transparent about their environmental, social, and governance (ESG) performance, including their contributions to local economies. Companies worldwide have met this trend with increasing uptake of what is now commonly called “sustainability reporting” (IFC’s Sustainability Performance Standards and the GRI Reporting Framework, 2010). Despite these encouraging developments, most institutional investors do not yet ordinarily incorporate social and environmental considerations into their investment decision-making process.

Why consider sustainability in the first place?

A company’s position in the financial market depends on its potential to generate value and is determined by its individual characteristics in relation to those of its peers. Sustainability trends such as climate change, resource scarcity or demographic change shape the competitive environment in which companies operate by introducing long-term sustainability opportunities and risks. (SAMS White paper, 2011)

### 1.2. Research Problem

The International Finance Corporations’ Sustainability Performance Standards define sustainability reporting as a form of internal monitoring, management and external communication, which enables organizations of all sizes to meet the growing information needs of their various stakeholders, both internal and external(IFC,2010). In addition, reporting also helps reinforce internal capacities to engage the full organization in defining a

corporate sustainability strategy, setting public targets, implementing plans, and reviewing results. Financial and non-financial performance and outcomes should be linked to improve understanding of sustainable value creation. The investor needs should be met by material, timely, consistent, and comparable information. Data that may be dispersed in different parts of the organisation or its supply chain should be brought together to support internal and external decision making (Deloitte IAS Plus (2012)). While there is a number of frameworks that have been developed with the development of this phenomenon around sustainability reporting, it is still argued that organisations publishing non-financial reports do not understand what information is really required from an investor perspective (De Fine, 2010) thus if this information presented lacks relevance to the investor, it will seldom be used in the investment decision making process

The Forum for Corporate Sustainability Management (CSM) at IMD has conducted an extensive research project on the industry specific business case for sustainability. This research indicated, firstly, that companies cannot always quantify the important influences that affect value drivers either directly or indirectly, and they often attribute them to “license to operate” or brand value and reputation. So it is difficult to express the business case in the traditional corporate language of financial numbers. Secondly, companies are content enough to work on the dual assumption: that their sustainability-activities are “the right thing to do”, and the extra costs they imply are in any case marginal. Thirdly, companies hesitate to cite self-interested reasons for the good things they are doing. But one result is clear: nearly all companies prefer a cautious, step-by-step approach, with more focus on increase in operational efficiency than on technological breakthrough or untested business models. Thus given that these ongoing efforts will undoubtedly be more run-of-the mill, but nevertheless have sustainable impacts, even after the hype has disappeared (PMF ,2004).

### **1.2.1. Why was the problem selected**

More and more members of the global investment community including leaders of sustainability standards in emerging markets see sustainability reporting as an opportunity for more dynamic engagement between investors and business. As proven in recent research by Voster (2001), a clear link between good ESG performance and the ability of

enterprises to be profitable and survive turbulent times has been proven. Industry experts thus agree that there is little evidence that can confirm that investors are demanding specific information with which to make investment decisions (De Fine, 2010). Given these developments in institutional reporting, investors do not change from the status quo and seemingly do not incorporate social and environmental considerations into their decision-making.

Investment decisions in the mainstream do not take possible risks or rewards of social and environmental factors into account, except where they incorporate short-term stock price implications (Lydenberg and Sinclair, 2009). The fundamental question is not whether the current financial markets can be used to fix social and environmental problems, although in certain circumstances they certainly can, but whether social and environmental concerns can drive fundamental changes into the current markets, which today create as many social and environmental challenges as they address (Lydenberg and Sinclair, 2009).

Ferns et al (2008) argued that there was little research that showed effectiveness of non-financial reports. Because few investors understand the detail contained within these reports, they therefore cannot use them as expected (Stapleton and Woodward, 2009).

From the problem statement the following research questions emerge:

- Do institutional investors perceive that there is a correlation between non-financial reporting and the financial performance of the firm?
- Do institutional investors thus use non-financial information in making investment decisions?
- If so, what aspects of non-financial performance influence the investment decision making process?
- Is the non-financial information currently provided to investors useful in creating value in the future?

### 1.3. Research objectives

To answer the proposed research questions, the following objectives will be pursued:

- Assessment of current non-financial reporting structures and whether this information is used by investors in making investment decisions.
- Explore the key elements of sustainable reporting that will influence the investment decision making process of an institutional investor.
- Assessment of how non-financial information currently reported by corporations creates value for the firm in the future.

### 1.4. Research Scope

The research scope will be limited to the context of South African investors, thus institutional investors outside South Africa will fall outside of the research scope. Institutional investors in this study will also be limited to asset and fund managers, research analysts, investor relations officers and portfolio managers. Thus individual(retail) investors will fall outside the scope of this study due to the challenge of accessibility, government and government fund managers will also not form part of the study.

Non-financial information will comprise of social and environmental information and communication around governance issues. The aim of this study is to contribute to awareness of sustainability as an investment tool to be applied in the normal course of investment decisions made by institutional investors. In this regard, sustainability is not meant to replace the current methods of investment analysis but rather to be incorporated as part of the assessment of management competencies, corporate governance risk and corporate longevity (Mays report, 2011).

#### 1.4.1. Definition of key concepts

**Institutional investors** are defined as financial institutions that accept funds from third parties for investment in their own name but on such parties' behalf. They include pension funds, mutual funds and insurance companies (OECD,2011). Generally, the primary concern

of an investor institution is to minimize risk while maximizing return, as opposed to a speculator, who is willing to accept a higher level of risk in the hopes of collecting higher-than-average profits. For purposes of this study, will be limited to institutions such as asset and fund managers, research analysts, investor relations officers and portfolio managers namely Public Investment Corporation of South Africa, Allan Gray, Old Mutual Inc. and Nedbank Investments. As the primary users of financial reports, the investor community is engaged in businesses to a far greater extent than other stakeholder groups thus Government, individual investors and other stakeholders are excluded from this study. (De Fine, 2010)

**Non-financial information:** for the purposes of this report the term ‘non-financial’ shall be used to explain social and environmental issues, for the purpose of this report it has been selected as a suitable umbrella term (De Fine, 2010). Within this study, the terms non-financial and sustainability shall be interchangeable (De Fine, 2010).

**Sustainability reporting:** A sustainability report is an organizational report that gives information about economic, environmental, social and governance performance (GRI Reporting Framework, 2010).

**Sustainability Investing** is a long-term investment approach that integrates economic, environmental and social considerations into financial analysis for the selection and retention of investments.

## Chapter Two

### 2. Literature review

Before the 1980s organisational performance was characterised by traditional cost-accounting principles and orientation, which Banks and Wheelwright (1979), Hayes and Garvin (1982) and Kaplan (1983) criticised as promoting short-term thinking (cited in Gomes, Yasin & Lisboa, 2004). This underpinned the need for an integrated performance measurement (Gomes et al. 2004). A study by the European Centre for Corporate Engagement found that from the investor side, SRI remains a niche segment in the industry with respect to the incorporation of ESG factors in investment decision making. The reason being that the standard performance objective maximising financial returns on managed assets typically did not lend itself to analysis of ESG impact on the portfolio for as long as the impact does not directly impact the company's bottom line in subsequent quarters given the shrinking time horizon of investment decisions linked with fund managers compensation; which is narrowly defined by short term benchmarks. These therefore provide little incentive for these investors to focus on the long term performance of their investments or their impact on anything but the bottom line (ECCE,2007).

Investors play an important role in promoting long-term sustainable organisational success albeit they form only a small element of effective corporate governance (IFAC, 2012). The lack of attention to ESG factors has led to passive type of investment fuelled by short termism which has also contributed to short term thinking of companies (IFAC,2012).

Although corporate commitment to sustainability is increasingly evident in private and public-traded entities, such as those offered by the Global Reporting Initiative (GRI), Integrated Reporting Frameworks (IRC), and disclosure of corporate sustainability practices through sustainability indexes such as the Dow Jones Index and JSE sustainability index (as cited in Ohlson de Fine,2010).

Bebbington et al. ,2007; Hopwood et al. ,2010 and Burrit and Schaltegger ,2010 in CPA Australia(2011) have questioned the internal sustainability accounting developments orientated towards improving management decisions, given the high-level performance models that have contributed to sustainability awareness.

### **The sustainability decision-making model**

A4S says that managers are rarely provided with the methodology and information needed to take their organisation's strategic sustainability objectives into account in a meaningful, robust and consistent manner. The A4S decision-making model has been developed to show how sustainability issues can be taken into account more effectively in day-to-day decision-making processes. The methodology is divided into 3 broad phases:

- 1) Undertaking a review of the whole product or service range to understand the impact of the of the organisation's main sustainability objectives. If additional major sustainability impacts are identified during this process the organisation's overall strategy may need amendment.
  
- 2) Analysing the life-cycle of particular products and services to determine the impact of the key sustainability factors identified during the first more general review. This is an iterative process involving, for example, discussions with in house manufacturing and/or suppliers and other stakeholders.
  
- 3) Understanding all the various options and reaching a balanced fully informed and documented decision as to how the sustainability performance of the particular product or service can be improved

Investors are becoming more sophisticated in their investment approaches and gravitating to:

- Greater ESG integration
- Certain types of disclosures and key performance indicators
- Assessing financial outcomes of ESG factors

Thus investors have derived multiple approaches to Responsible Investment (RI) namely:

**Negative ESG screening**—excluding specific industries or sectors, such as alcohol, gambling and tobacco

**Positive ESG screening**— or “best-in-class” investing, whereby the scope of the investable universe is restricted to highly rated ESG companies

**Engagement**—involving a dialogue between a shareholder and a company with the aim of improving the company’s value through greater incorporation of ESG factors

**ESG integration**—involves integrating specific ESG criteria into valuations of a company

The study by the Financial Services Research Forum (2012) conducted a comparative analysis between RI strategies and barriers to usefulness on ESG information in the investment decision making process (Slager, R., and Moon, J. 2012).

Reasons cited included the following:

- Across the screening, engagement and integration strategies, ESG data was found not to be specific or in-depth enough for client demands. ESG data was not always relevant and up to date with company improvements.

- Integration strategies were also frustrated by the fact that data is not material for financial performance or was found to be only material for long term investments thus respondents also found it difficult to use it across companies as a comparative analysis over time.
- Engagement strategies were flawed by external ESG providers not holding any shares thus had little influence in the request for information.

## 2.1 The role of institutional investors

OECD Principles of Corporate Governance talk to the underlying assumption that shareholders can best look after their own interests, provided they have sufficient rights and access to information. However given the increased presence of large institutional investors in the last decade an expectation for highly skilled and well-resourced professional shareholder fostered the expectation would use their rights to promote good corporate governance in the companies they invest in (OECD,2011). According to OECD reports, in 2009 institutional investors managed and estimated \$53 trillion worth of assets in the OECD area including \$22 trillion in equity making them a major force in many capital markets (OECD,2011).

The nature of institutional investors has changed over the years into a complex system of financial institutions and fund management companies with their own corporate governance issues and incentive structures (OECD,2011). The OECD Principles were thus derived to make recommendations in the level of transparency and management of conflicts by institutions and co-operation between investors (OECD,2011). Private sector and public sector have played a critical role as agents and policy makers in improving corporate governance outcomes of institutional investors behaviour. Thus resulted in enhanced collaboration among institutional investors through the establishment of industry associations to share in the cost of monitoring and voting and has yielded positive results. From the public policy perspective, prudential regulations have limited holdings in individual companies by institutional investors and placed restrictions on incentive schemes which may change their behaviour unintentionally.

The review by the OECD showed that given a conducive environment, institutional investors can play an important role in jurisdictions characterised by dispersed or concentrated ownership. This role would be facilitated by both private and public policy action (OECD,2011). However institutional investors are driven by different actions from other shareholders and are driven by cost, benefits and objectives in their capacity as agents on behalf of beneficiaries and are not directly remunerated on the basis of performance of portfolio companies, the exception of course being private equity and hedge funds where incentives are as high as 20 percent of fund performance. They are remunerated often on the basis of management fees based on the volume of assets under management. Thus fund performance whether absolute or relative is reviewed by investors and mandates that often run over a three year period (OECD,2011).

This incentive structure thus favours a focus on increasing the size of assets under management, which would often result in neglecting improvement of portfolio performance. This incentive structure is also cited as a contribution factor to churning of assets thus increasing the commissions of transactions. A decline in average holding periods has been noted worldwide, as institutional investors have been pressured by the rising importance of frequency traders (OECD,2011). A study of the of leading European pension funds found that fund managers believed that the investment horizon of their pension fund should be 23 years, but in reality holding periods were averaging approximately six years (Hesse., A,2008). This however does not mean that short termism among institutional investors can be directly correlated to investor behaviour in relation to ESG matters (IFAC, 2012). Institutional investors are not necessarily short-term oriented if they buy and sell the same shares on a regular basis.

In addition, the incentive structures influencing many institutional investors and fund managers are influenced by conflicts of interest in their ownership structures. i.e ownership by banks and insurance companies and their relationship to company sponsors of pension plans and their control of funds traded between themselves (OECD,2011).

This might work to the disfavour of investors. Key policy issue cited are concerns as to whether institutional investors are only short-term investors, or at least promoting short-term thinking by boards and managements (OECD,2011).

In the case of pension funds, especially defined benefit schemes is often cited where in principle their liabilities to their beneficiaries stretch over many years, however they very often issue short-term mandates to their investment managers who in turn have their own short-term incentive systems.

Smaller players are neglected in that the large institutional investors often locked into the shareholding of most large companies on a long-term basis since for regulatory or other reasons, diversification and index investing is the norm(IFAC,2012).

From this it could be deduced that these investors have only a short term outlook, but they are long-term shareholders even if they buy and sell the same shares on a regular basis, and even lend them for a fee (IFAC, 2012). They therefore have an incentive to encourage good corporate governance in their large portfolio companies since it is the only way they have to earn greater returns. A number of institutional investors already recognise this. Nonetheless a number of large institutional investors are not acting in this way. Institutional investors should, thus have an incentive to encourage effective corporate governance in their large portfolio companies since it is the only way they have to earn greater returns (IFAC,2012).

Private initiatives to encourage such institutions to become engaged should be supported and policy should facilitate this development perhaps through careful definition of the obligation to monitor large holdings. The Conclusions (OECD, 2010a) by the OECD also noted that the financial crisis served to underpin long held concerns that the monitoring of boards by institutional investors was generally deficient compared to what was required. Shareholders were described as being either passive or reactionary in the exercise of their voting rights, perhaps mechanistically relying on proxy advisers, and failing to sufficiently challenge boards. On the other hand, there is also a countervailing view that institutional investors are already much too effective thereby constraining management in favour of short-term policies. Clearly, institutional investors have an

important role to play in promoting good corporate governance, even though they represent only one small part of an effective corporate governance system (IFAC, 2012).

A major feature of the institutional investors' landscape in recent years is the advent of ESG investing as an asset class, primarily as a result of the UNPRI Principles. The UNPRI process involves asset owners and asset managers, in total around 500 institutions. Most of these signatories classify themselves as active managers although over 85% of asset owners have at least some funds that are passively managed. In their recent report, the UNPRI reports progress in implementing their Principles. However, being a mixture of governance, environment and social factors it is difficult to determine the economic drivers. However, some observations are useful. Thus they note that "in the global market as a whole, ESG integration is being implemented across 8% and 6% of listed equities in developed and emerging markets respectively" (UNPRI, 2011). Approximately 90% of signatories were involved in formal or informal collaboration with other investors on ESG issues and more than 35% collaborated to a large extent.

## 2.2 Institutional investor collaborations

IFAC (2012) still cites two major challenges with respect to co-ordinated efforts with respect to integrated reporting, firstly on whether ESG information is given credence by investors. Secondly is the fact that there is little consensus among investors and companies on key ESG investment criteria and how ESG information links to financial performance and long term sustainable success.

But ESG integration has rapidly moved from scattered initiatives to organized joint programmes (Bourghelle, Jemel, Louche, & Leuven, V, 2009). Over the last few years, there have been several coordinated efforts to encourage the integration of ESG into firms' valuation and investment making processes such as the Enhanced Analytics Initiatives (EAI) and the Principles for Responsible Investment.

The EAI —is an international collaboration between asset owners and asset managers aimed at encouraging better investment research, in particular research that takes account of the impact of extra-financial issues on long-term investment (Bourghelle et al.,2009).

The PRI identifies the role of institutional investors, as having a duty to act in the best long-term interests of its beneficiaries. In this fiduciary role, it is believed that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). Thus the PRI's view is that applying these Principles may better align investors with broader objectives of society (The Principles for Responsible Investment, 2012).

The PRI principles can thus be outlined as follows:

1. To incorporate ESG issues into investment analysis and decision-making processes.
2. To be active owners and incorporate ESG issues into ownership policies and practices.
3. To seek appropriate disclosure on ESG issues by the entities in which they invest.
4. To promote acceptance and implementation of the Principles within the investment industry.
5. To work together as signatories to enhance our effectiveness in implementing the Principles.
6. For each participant to report on their activities and progress towards implementing the Principles.

At the end of 2008, the PRI and the EAI announced their merger under the PRI name. Their merger is aimed at supporting the generalization of ESG research and the effective inclusion of ESG information into investment decision practices. The consolidated approach will represent a single, powerful voice within international investment markets, continuing to encourage the production of better integrated and longer term research (Principles of Responsible Investing as cited in Bourghelle et al.,2009).

The Investor Network on Climate Risk (INCR) is another important initiative (Bourghelle et al.,2009). The INCR is “a network of institutional investors and financial institutions that promotes better understanding of the financial risks and investment opportunities posed by climate change”. INCR is coordinated by Ceres, a coalition of investors and environmental groups working to advance sustainable prosperity (Bourghelle et al.,2009). These collaborations by institutional investors indicate the need for further research in the overall impact and benefit that can be derived from understanding the importance of integrated reporting in the investment decision process.

Given that institutional investors as long term investors are most exposed to the social and environmental risks embedded in the companies they invest in has resulted in the widespread collaboration in such initiatives with the use of benchmark indices such as JSE SRI Index, Dow Jones SRI Index in the investment means that, as they grow, institutional investors increasingly become permanent owners of the shares in companies, thus sustainability considerations would benefit these long term investors (Mays Report, 2011).

### **2.3 Non- financial information reporting in the South African context**

There is limited willingness in the South African investment community, comprising both asset managers and analysts, to take sustainable development into consideration in decision making. The sector seems unwilling to consider either the ethical dimension or the ‘business case’ for this. Whereas numerous high-profile fund managers in North

America or Europe have stressed the importance of non-financial risk management (Sonnenberg & Hamann, 2006) ,such awareness is rarely encountered in South Africa.

Currently, non-financial reporting in the South African context is more comparative with specific sectorial focus (JSE SRI Index, 2011). Less than five percent of listed companies provide any information that would allow for the effectiveness of their stakeholder engagement procedures to be assessed. Although companies stress the importance of engagement, very few actually discuss who they have spoken to, when and for what reason (JSE SRI Index, 2011). This trend is unique in developing markets as opposed to developed markets.

South African pension funds, which represent a significant proportion of investment on the JSE, have hesitated to embrace all the principles of the triple bottom line, particularly compared with their international counterparts (JSE SRI Index, 2011). This assertion is based on observation and a lack of participation on the part of pension funds that focus on the triple bottom line reporting and its consequence for investment (JSE SRI Index, 2011).

An underlying factor is that the investing public in South Africa has low levels of awareness or is not concerned about the integration of social and environmental issues in investment decision-making. This is also apparent in the relatively low levels of shareholder activism as found in a study by Sonnenberg and Hamann (2006).

In some instances, SRI is seen as a luxury with little relevance in South Africa or Africa. This ignores the important contributions that SRI and corporate citizenship can make to the competitiveness of companies and regions, especially in the long term (Sonnenberg and Hamann, 2006).

A study by Buzby (1975) in Myburg (2001) was conducted on 39 items of financial and non-financial information disclosed in annual reports presented to a select group of users, namely financial analysts. The outcome of the study revealed that “many items of information which analysts believed was important, were not being adequately disclosed

and that there was little correlation between the relative importance of the items and the extent of their disclosure” (Myburgh, 2001,p.202).

Further studies by Firer and Meth (1992) in Myburg (2001) looked at the extent of non-statutory information disclosed in annual reports of South African companies, and concluded that there was little correlation between investor information requirements and disclosure of such information in annual reports.

## **2.4 Investors’ perceptions of the usefulness of non-financial reporting in decision making**

“Financial performance tells me what a company has already done. Non-financial performance tells me what it is likely to do.”(SAM White paper, 2011)

“Capital market participants like to perceive themselves as rational beings, driven purely by hard and reliable financial information. It may come as a surprise therefore that a wide range of studies point to a significant impact of non-financial factors on a company’s financial performance” (Fieseler and Hoffman, 2012,p.2).

Shiller (2000) has outlined the influence of cultural and psychological factors of financial decision-making process in the sphere of behavioural finance (Fieseler & Hoffman, 2012). These factors can thus be deemed as being subjective thus also indicating some influence in the reliance of information provided. Bourghelle et al.,(2009) argue that collective beliefs play an important role in a company’s stock valuation and investment strategies because financial market participants coordinate their actions through dominant conventions. Following this logic, the integration of ESG information will become a mainstream practice if, and only if, there is a shared belief among investors that ESG information is relevant (Bourghelle et al.,(2009)

The research conducted by Guyatt (2005, 2006a) shows that dominant external and internal conventions could impede fund managers ability to integrate ESG information into investment decisions (as cited in Bourghelle et al.,2009). “External conventions relate to collective behaviour that prevails across the market, while internal conventions refer to conditions that are particular to an investment organisation like the internal team structure, culture, incentive system and attitude towards SRI (Bourghelle et al., 2009). This research found that short-termism and movement towards defensible investment decisions was the main behavioural impediment to the integration of ESG dimensions by institutional investors (Bourghelle et al.,2009). This finding was corroborated by recent studies conducted by BSR in 2008 and McKinsey in 2009 as cited in Bourghelle et al.,(2009). According to these surveys, some investors and analysts recognize that ESG factors can impact financial performance, however they judge the potential risks generated and value created too long-term compared to their investment horizon.

One of the other dominant and recurring themes that emerged from this research is the narrow company valuation model that has become widely adopted across the investment community.

It has become standard practice for estimates of company valuations to over-emphasise the importance of tangible, financial criteria to derive the net present value of a stock’s expected income stream, such that cashflow return on investment can be estimated. A study on Swedish investors by Hellman (2000) cited in Bourghelle et al.,(2009) found that in making such estimates, close attention is paid to financial ratios such as return on equity, return on capital employed, sales growth, price/earnings etc.

As mentioned in Arthur (1995), expectation formation can become self-referential (cited in Bourghelle et al.,2009).

“The integration of other ‘intangible factors is often overlooked in this valuation process and a narrow framing of the valuation criteria is not only conventional at the external’ market level, but is also ingrained within the internal’ conventions and processes that prevail within investment institutions” (Bourghelle et al.,2009).

## 2.5 Source credibility

Pornpitakpan (2004) as cited in Schwarzkopf (2006) has proven that the perceived credibility of the source of information often plays a role in decision making (Schwarzkopf, 2006). The importance of source credibility in accounting and investments have long emerged in studies of auditors' judgements, audit committee decisions, lenders deliberations and investor confidence in studies by Barmer (1983), DeZoort et al., (2003), Beaulieu and Rosman (2003) and Hirst et al. (1999) respectively as cited in Schwarzkopf (2006). By ranking these sources of corporate information it should provide insight into the role that these sources play in investors' perceptions of the business reporting network (Schwarzkopf, 2006).

Investors' value of source credibility is often assumed, but the extent to which they value this factor across decision context is yet to be examined. Understanding the propensity of investors to use this information contributes to the understanding of investment decision making as exposure now factors access to non-financial data as well (Schwarzkopf, 2006).

From these studies we can conclude that the perception of source credibility may at times be influenced by questionable attributions of source accountability and independence, which results in the decision context affecting the value that the investor places on a source of information as opposed to the information itself (Schwarzkopf, 2006). This will have implications for how the reporting on non-financial information presented to investors is viewed in light of the long-term sustainability of the information itself in the decision-making process.

## 2.6 Why would responsible investment fall short of its purpose

Given that responsible investment (RI), represents the voluntary non-governmental approach by the financial community to reforming itself it is therefore fair to test the effectiveness and viability of this form of self-governance by asking as to whether it causes change in companies for environmental and social good? (Joly, 2010). Secondly if it is more responsible when it comes to protecting its principals against classic agency

problems? And lastly, as to whether it is a good response to the problem of short-termism? (Joly, 2010)

A study by Joly (2010) discusses responsible investment against the background of the recent financial crisis. The study outlines how as a responsible form of financial management, RI should have “spotted the roots of the finance crisis and worked to have the system deal with the excesses at an early stage” (Joly,2010). The consensus in the industry is that it should at least have saved investors from severe losses by pulling money out of shares early on or advising clients to do so. Responsible investors have been laggards with regard to the current crisis, “neither identifying it early nor doing anything to try to prevent or contain it”. Thus the study questions if these initiatives can be trusted in the future to help protect the retirement savings of principals.

The underlying principle of RI/ESG/SRI is that a pension fund or asset manager can make a competitive return on investment for principals by buying the stocks of companies that go about their business in a way that actually improves environmental and social conditions in the world while making a good profit (Joly, 2010). The idea is that the concept of sustainable development, expressed in companies through CSR programs, is taken up in the investment world by giving preference in portfolio composition to the better environmental and social performers and/or by influencing companies to achieve better ESG performance in practice (Joly, 2010).

Thus Joly (2010) concludes that RI falls short of its purpose as the voluntary nature of compliance creates the following problems:

1. Executive compensation: excesses are inimical to economic fairness;
2. Tyranny of the indexes and tracking error, which reinforces short-termism and lemming behaviour;
3. Short-termism, which short-circuits true sustainable development investment and the integration of climate change impacts in investment strategy;
4. Engagement, which is generally at the margins rather than at the core of RI;

5. Failure of private equity funds to integrate ESG;
6. The inability of investors and investment managers to correct the externalization of environmental and social costs; and
7. The failure of companies to make explicit the ethical judgments involved in core strategic and budgetary decisions.

Progress on each one would improve with application of governmental regulatory measures.

## 2.7 The usefulness of non-financial information

A study by Flostrand and Strom (2006) found that analysts tend to rely more heavily on forward looking non-financial information than historical non-financial information. Information has value relevance if it is used by analysts in the valuation process, as an alternative form of measuring information usefulness. Thus policy makers and preparers of business reporting need to take into consideration that business reports now have to include information that is relevant in predicting future performance. The focus is therefore more on leading as opposed to lagging indicators of performance (Flostrand & Strom, 2006). Increasingly more information becomes unsuitable for standardisation and firms are now expected to identify which information is relevant to investor reporting and report this voluntarily.

Arvidsson (2011) proved that the increasing focus of non-financial information related to intangible assets in corporate disclosure increased the demand from both the regulatory and demand side (Arvidsson, 2011).

The primary challenges with sustainability reporting, as cited by Ohlson De Fine (2010), is the difficulty in measuring intangibles consistently and cost effectively. Yet commonly accepted measures for reporting are required for an investor to make an informed decision using non-financial reports (Choudhuri & Chakraborty, 2009 as cited in De Fine, 2010).

## 2.8 Communication gap in investor reporting

Even with the introductions of the GRI framework, sustainability reporting differs significantly from one organisation to the next (Dittrick, 2007). Unlike standardised accounting practices, it results in difficulty in comparative capabilities as investors use non-financial information in a decision-making process.

Complexities in communication further arise from the tripartite communication of these reports between the organisation and investor community, and thus discrimination of information can become rather complex in trying to facilitate a common understanding of what is being reported.

Stepleton and Woodward (2009) in Ohlson de Fine (2010) suggest that organisations seldom fulfil their role as disseminators of information to the relevant stakeholders whilst also trying to avoid over-complicated reporting which may lead to further misinterpretations of information (Lever, 2006 in Ohlson de Fine, 2010).

Signitzer and Prexl (2008) have concluded that, although sustainability experts possess high levels of skill, they lack the ability to effectively communicate, which thus results in the increased focus on Corporate Social Communication through intermediaries that form part of strategic communication, i.e. investor relations. The US National Investor Relations Institute defined investor relations as “a strategic management responsibility that integrates finance, communication, marketing and securities law compliance to enable the most effective two way communication between a company, the financial community and other constituencies, which ultimately contributes to a company’s securities achieving fair valuation” (Isa, 2010). Fieseler and Hoffmann (2012) subsequently described it as a function that provides the financial community-critical input on the state, the success and strategic development of an entity beyond any financial reporting mechanisms.

The challenge however, is that investor relations is commonly perceived as a finance function rather than a communication function (Laskin, 2009 in Ohlson De Fine 2010), but reality is that it incorporates both functions, and thus synergy between the two functions is necessary. Organisations that want to bolster their market performance by winning over the financial community thus need to regard their financial communication or investor relations function as more than just a tool for financial reporting (Fieseler & Hoffman, 2012).

The guiding theme is that, when done well, sustainability reporting is a business process that can create internal management benefits as well as enhance reputational value (IFC,2010).

## 2.9 Shareholder value creation

Ballow, Burgman and Molnar (2004) state that the future value of a company is an important element in shareholder value creation, but a difficult element to understand by management (Ballow et al., 2004). Sustainable value creation and financial results ultimately flow from the performance across all eight drivers of sustainable success, as well as how effectively ESG factors have been embedded into the way an organization is directed and managed (IFAC,2012). Reporting at business level has however focused on financial performance or whenever companies do present integrated reports that would disclose the sustainability or ESG related information it is often not presented in a useful form to the investor. This information is often presented in a disjointed and unrelated manner so the essence of its relationship to the company strategy, operations and financial information is not clear to its audience hence the rationale behind the integrated reporting framework from the International Integrated Reporting Council (IFAC,2012).

A company's stock price incorporates the market's perception and valuation of its current operations and future growth prospects. However, its management lacks the tools to give them insight into how the market perceives and values its growth potential, and because

of this imbalance management of corporations under-manage and ignore what might be a significant portion of their company's valuation (Ballow et al., 2004).

The competitive advantage derived from sustainable reporting can be regarded as an 'intangible asset' which current accounting standards battle to quantify and measure. Executives therefore need to understand and see this benefit as it forms part of the components of future value (Ballow et al., 2004).

Hessel et al., (2005) in De Klerk and De Villiers (2012), state that "a value creation perspective will result in an increase in market value" as shareholders regard environmental efforts as a means to increase competitive advantage and improve financial returns to investors (De Klerk and De Villiers 2012,.p.6).

Shareholder reaction to news or events about companies' social and environmental performance has an impact on share prices as outlined in studies by Blaconiere and Patten (1994), Dasgupta et al., (2006), Hamilton, (1995) and Patten, (1990), which suggest that information about a company's environmental and social performance is value relevant for investment decision making (De Klerk and De Villiers, 2012).

Findings reveal that information symmetry between shareholders and managers of the firm influences the shareholders' risk assessment of a company, thus concluding that it is not sustainability reporting alone that causes the level of market value, but that investors use non-financial reporting together with other relevant sources of investment data to value a company stock. Thus non-financial reporting can be regarded as 'value-relevant' in investment decision making (De Klerk and De Villiers, 2012).

Given that Cormier et al, 2005, Dhaliwal et al., 2011 and Healy & Palcpu, 2001 in De Klerk and De Villiers (2012) state that information about risks and liabilities influence shareholders' risk assessment and thereby share valuation; thus if investors do not possess this information, it often results in incorrect valuations of the company share price.

In De Klerk and De Villiers (2012), prior survey, interview and experimental research by De Villiers and Van Staden (2010a), Solomon and Solomon (2006), Chan and Milne (1999), Holm and Rikhardsson (2008) indicated that shareholders call for environmental information to be disclosed and these investors privately gather and apply this data in their decision-making process of valuing companies.

As detailed in De Klerk and De Villiers (2012) shareholders need information regarding the environmental risk of a company and how it affects future cash-flows and liabilities (Al-Tuwaijri, Christensen and Hughes II, 2004). This information about risks and liabilities influences the shareholders' risk assessment and ultimately the share valuation (De Klerk and De Villiers, 2012).

In assessing the information used by shareholders to value a company De Klerk and De Villiers (2012) found that share prices of companies with higher levels of sustainability reporting were higher (De Klerk and De Villiers, 2012). The challenge in the investor community as outlined in an interview by Tom Rotherham of the UPRI in 2009, is that competition amongst firms does not warrant active participation and awareness to publicised as they do not see why it would be important to assist competitors get a better understanding and awareness of ESG issues if businesses think that these strategies are fundamental to value creation. (Principles of Responsible Investment, 2012)

The given demand of stakeholders that including investors, regulators etc, for greater transparency in integrated reporting lead the Australian Government to commission *Corporate Sustainability – an Investor Perspective (The Mays Report)* in 2003. These are collaborative efforts that address investor needs. The report found that those companies which integrated sustainability activities into their core business had a lower risk profile thus proving that drivers and links between corporate sustainability activities and shareholder value do exist. (Mays, 2012)

## Chapter Three

### 3. Research Questions

#### Research Question 1

- Do institutional investors perceive that there is a correlation between non-financial reporting and the financial performance of the firm?
- 

*Research question 1 aims to explore if investors perceive whether there is a correlation between non-financial reporting and financial performance of the firm. It is assumed that this is a factor that would influence the use of non-financial information in investment decision making process given the perceived value that this information will add.*

#### Research Question 2

- Do institutional investors use non-financial information in making investment decisions?
- 

*Research question 2 cements the reason for the study of sustainable reporting, it will thus assess the capabilities of internal and external investment managers to incorporated ESG issues in their investment decision making process. As research has shown the vast availability and variations of this type of reporting but has not linked the use of this information for its intended purpose for investors especially value investors who take on a long term view.*

### Research Question 3

- If so, what aspects of non-financial performance influence the investment decision-making process?

*Research question 3 outlines the specific elements of non-financial reporting that investors would deem important in their decision making process thus aligning current reporting structures and frameworks to the demand investors currently have. It is expected that definitions will differ per individual and be of both an objective and subjective nature.*

### Research Question 4

- Is the non-financial information currently provided to investors useful in creating value in the future, in light of competitive advantage derived from sustainability reporting?

*Research question 4 will explore the value derived once this information is available to the investor in the correct form, in a timely fashion and how this will assist the investor gain competitive advantage by applying principles of sustainability in their investment decision making process thus outperforming its peers in the market*

## Chapter Four

### 4. Research Methodology

The purpose of the study was to understand the value derived by institutional investors in current sustainability reporting and its use in their investment decision-making process. Given that evidence of the fundamental elements of sustainability reporting that could influence investment decision making is limited. The research methodology was thus exploratory in nature and used qualitative techniques such as structured interviews to gain in-depth insight into investor demand for non-financial reporting. The study looked not only at what is immediately apparent i.e whether the investors use non-financial information or not, but also what lies behind what is immediately apparent (Saunders & Lewis, 2012) i.e the factors on sustainability reporting that these investors deem important thus would influence their investment decision making process.

#### 4.1 Research design

In this study, a qualitative and explorative design was followed. The purpose of the research was to explore, understand and discover whether non-financial information is in fact used in investor decision-making and understanding the factors that these investors deem an important component of any sustainability reporting contained in the non-financial reports published by companies.

##### 4.1.1 Qualitative design

Qualitative research is conducted to generate knowledge concerned with meaning and discovery (Burns and Grove, 2005). Thus a smaller, more focussed sample was used in our analysis. Data can thus be organised to describe differences in perception of

importance of sustainability reporting in the decision-making process of the institutional investor which will be derived from structured interviews to be conducted.

In this particular study, quantitative methods will not be suitable as they would present a measure of limitation in analysis of the derived data, as outlined by Gerrish and Lacey (2010) in Burns and Grove (2005). Quantitative research is limited to being observational through the use of surveys and questionnaires. In a survey, structured questions with tick boxes can only provide coded data which would come in a numerical form and therefore it is used to support our data gathering rather than being a main data gathering instrument. The analysis thereof can only be limited to a description and comparison of a relationship amongst variables, i.e. the use or non-use of non-financial information by institutional investors in their investment decision-making process, and not to unpack the underlying reasons as to why and how investors apply this information in their decision-making process.

This process is different from data generated from quantitative research which is mainly numerical; data collected in qualitative research was primarily text-based and will contain themes and categories evaluated subjectively. Data management in such qualitative research involves three important aspects: data storage, transcribing audio sources, and cleaning the data (Wahyuni, 2012).

Given the nature of the research enquiry, a qualitative approach was preferred in order to obtain the views of investors on the relevance of non-financial information to their investment decision process. This allowed the research to be open and for the themes to be expanded as the research progresses. This was imperative in gaining an in-depth understanding and addressing the research questions in-depth.

An inductive approach was used in the development of theory of the value derived from use of non-financial information in investment decision-making by investors as a result of analysing data already collected through observing patterns and repeated occurrences of phenomena to formulate a speculative hypothesis which will be investigated, with the view of developing some general conclusions and theories (Saunders & Lewis, 2012). The research design was thus descriptive and analysed and explained recent occurrences in the field.

### 4.1.2 Explorative design

Exploratory studies are well suited to qualitative methods such as the chosen structured interviewing method as it would allow for flexibility (Saunders & Lewis, 2012).

The explorative design aimed to seek new insights, ask new questions and assess topics in a new light (Saunders & Lewis, 2012). It was used to investigate what qualities and characteristics are associated with a particular issue. In this study these could be described as the key variables that should be factored in suitability reporting and would influence the decision-making process by institutional investors. It provided tentative answers to questions already posed that need to be followed up through more detailed research for dependable results (Saunders & Lewis, 2012). The study was conducted through consulting academic literature and interviewing institutional investors through structured interviews.

The focus was initially broad – exploring the use of non-financial information in the investor decision-making process – and become narrower as the research progresses and addresses the key elements taken into consideration by institutional investors in analysing sustainability reports in their investment decision-making process (Saunders & Lewis, 2012).

### 4.2 Unit of analysis

The unit of analysis was classified as the perception of institutional investor as to the use of non-financial information in the investment decision-making process based on their day to day investment decision making.

### 4.3 Universe

Our universe comprised of what has been defined as the investment community (institutional investors). These comprised of organisations that represent end-asset owners who hold long-term retirement savings, insurance and other assets (Principles of Responsible Investment, 2012). Examples include pension funds, government reserve funds, foundations, endowments, insurance and reinsurance companies and depository organisations. In addition, Investment Management companies that serve an institutional and/or retail market and manage assets as a third-party provider (Principles of Responsible Investment, 2012).

### 4.4 Population

The population within the context of this study was what has been defined as institutional investors, (Table 1) and their mandate and characteristics have been adopted from Ohlson de Fine, 2010 as modified from Juravle & Lewis (2008).

The institutional investors detailed below would as part of their core function, make investment decisions with a long term outlook as opposed to retail investors who have a short-term investment philosophy and would derive no benefit from long term objectives derived from sustainability reporting. Hence these type of investors have been excluded from the study.

**Table 1: Summary of investment community (adopted from Ohlson de Fine( 2010) as modified from Juravle & Lewis(2008)).**

Investor community	Mandate	Characteristics
Investment consultant	Provide investment advice on asset allocation, benchmarks and performance evaluation.	Involved in investment decision making. Known as “gatekeepers” driving SRI forward or holding it back.
Portfolio Managers	Manage day to day performance of particular investment within a fund.	Evaluated based on financial performance of their portfolios.
Fund Managers	Manage the day to day performance of particular investment within a fund.	Evaluated on financial performance of their portfolios.
Pension funds	Manage funds that provide retirement income to members.	Potentially the main drivers of SRI. Supervised by trustees who demand SRI from this group.
External Fund Managers	Advise institutional investors. and trustees	Guided by analysts recommendation.
Research Analyst	Provide investors with accurate and thorough information on organisation	Rarely understand ESG factors enough to integrate them into their reporting.

## 4.5 Sampling

Purposive sampling will be used to select respondents from the proposed universe (Saunders, & Lewis, 2012). Purposive sampling is defined as a form of non-probability sampling used particularly to select a small sample when collecting qualitative data (Saunders & Lewis, 2012). Subjective judgement was used to derive a sample that will best be able to help with the research question and meet the research objectives. The criteria for selection of the respondents can be described as follows:

- Primary users of non-financial reports
- Financially literate
- Actively engaged in evaluating investments

The following list of companies / institutional investors have been identified :

	<b>Name of entity</b>
1.	Momentum
2.	Riscura
3.	PIC
4.	Allan Gray Foundation
5.	Nedbank
6.	Sanlam
7.	IFC
8.	ABSA Capital
9.	IDC
10.	MMI
11.	Deloitte

The firms identified as participants must use such data in their day-to-day investment decision-making process. Such a sample will help us understand what is happening so we can make a logical generalisation as to the value derived from the use of non-financial information in investment decision making. Approximately 15 interviews were planned with senior employees of institutional investors from different South African organisations, but only Eight participants were obtained. In targeting specific companies, the study expects to gain investor perspective on the topic. The sample size of is in line with the heterogeneous qualitative research guidelines (Saunders & Lewis, 2012). The sample size is deemed appropriate given the research timelines and accessibility of participants with the focus mainly being on depth over breath of

information (Patton, 2002), after six interviews were completed a data saturation point was reached.

Advantages of purposive sampling are that it offers researchers a degree of control rather than being at the mercy of any inherent selection bias. Therefore, with this sampling technique, the research can deliberately seek to include “outliers” conventionally discounted in quantitative approaches. It allows for such deviant cases to illuminate, by juxtaposition, those processes and relations that routinely come into play, thereby enabling “the exception to prove the rule” in pre-existing groups, such as the ones selected in our institutional investors (Barbour, 2001).

## 4.6 Data Collection

### 4.6.1 Structured Interviews

Interviews are the most common form of qualitative research. For purposes of this research data will be collected using structured interviews that will be conducted face-to-face, this is a method of data collection using a questionnaire in which each respondent is asked the same set of questions in the same order by an interviewer who records the responses (Saunders & Lewis, 2012).

This method is appropriate given the small number of respondents expected to participate, i.e. 15 respondents, and will allowed for comparability of participant responses in order to answer the research questions. An interview schedule/questionnaire will be used as outlined in Appendix 2 which will guide the sequence and wording of the questions to be posed to respondents.

As per guideline by Wahyuni (2012), each interview should last no more than one and a half hours. After each interview, a debriefing was performed during which the participants are given the opportunity to ask questions, make comments or add any information that was not discussed during the interview.

The use of a structured interview method also allowed for standardisation, as questions were standardised this method increases the reliability and credibility of research data. Used as a tool for explorative research, it assist in gaining an understanding of whether institutional investors use non-financial reporting in their decision-making process. The outcome of the data thus examined and explained the statistical relationship between the demand for non-financial information and the value derived by investors in using it in their decision-making process.

Responses from the questionnaire specifically answered the research questions detailed above and met the research objectives of the study.

Using open-ended questions allowed for interpretation by the respondents in the way the question intends them to be understood to ensure content validity. It also allowed room for the interviewees to be reflective and critical of their own thoughts on the importance of integrating non-financial information in their day to day decisions as opposed to just completing a questionnaire where the process would be less reflective.

#### **4.6.2 Formulation of the Interview guide**

An interview guide was developed as per Appendix 3. The guide focused on obtaining insights from the institutional investors on the relevance of non-financial information in investment decision making.

The interview guide has been developed specifically for the theories applicable to this research. All interviews began with an outline of the interview process being explained to the respondents.

The guide covered the following salient points:

- A description of the study and purpose of study
- Statement that participation was voluntary and participant can withdraw without any penalty
- Reassurance that data will be kept confidential

The key issues were addressed through open ended questions posed in a conversational format.

#### 4.6.3 Data Validity and Reliability

The use of reliability and validity are common in quantitative research. Triangulation as used in quantitative research to test the reliability and validity can also illuminate some ways to test or maximize the validity and reliability of a qualitative study (Golafshani, 2003).

Eisner(1991) as cited in Golafshani (2003) defines reliability as a concept used for testing and evaluating quantitative research and this idea is often used in all kinds of research. If testing is identified as a way of information elicitation; then the most important test of a qualitative study is the quality of it. Eisner emphasises that a good qualitative study will help us “understand a situation that would otherwise be enigmatic or confusing”(Eisner,1992, .p58).

In contrast to the concept of a good quality research in a quantitative study having a purpose of explaining whilst quality concept of a qualitative study is “generating and understanding” (Stenbacka, 2001.,p551 as cited in Golafshani,2003).

If the validity or trustworthiness can be maximized or tested then more “credible and defensible result” (Johnson, 1997, p. 283) may lead to generalizability which is one of the

concepts suggested by Stenbacka (2001) as the structure for both doing and documenting high quality qualitative research. Therefore, the quality of a research is related to generalizability of the result and thereby to the testing and increasing the validity or trustworthiness of the research (Golafshani, 2003).

In any qualitative research, the aim is to "engage in research that probes for deeper understanding rather than examining surface features" (Johnson, 1995., p. 4 as cited in Golafshani, 2003) and constructivism may facilitate toward that aim.

An open-ended perspective in constructivism adheres with the notion of data triangulation by allowing participants in a research to assist the researcher in the research question as well as with the data collection. Engaging multiple methods, such as, observation, interviews and recordings will lead to more valid, reliable and diverse construction of realities. In a related way, a qualitative researcher can "use investigator triangulation and consider the ideas and explanations generated by additional researchers studying the research participants" (Johnson, 1997, p. 284 as cited in Golafshani, 2003). Triangulation is defined to be "a validity procedure where researchers search for convergence among multiple and different sources of information to form themes or categories in a study" (Creswell & Miller, 2000., p. 126 as cited in Golafshani, 2003).

In the study we used triangulation to test the validity and reliability of the study. This based on a pre-determined criterion by eliminating bias to increase the "truthfulness of the propositions about the social phenomenon (Denzin, 1978 as cited in Golafshani, 2003)

Reliability refers to the extent to which data collection methods and analysis procedures are consistent with research findings (Saunders & Lewis, 2012). For example, if the same instrument measurement scale is administered to the same individuals at two different times, the measurement is reliable if the individuals' responses to the items remains the same (Burns and Grove, p.374, 2005).

Such consistency refers to the measures that one will use to produce the same result if used in other occasions, in that when other researches, when using the same method and procedures will produce similar results (Saunders & Lewis, 2012).

The principal factors (Saunders & Lewis, 2012) that would threaten the reliability of research findings are outlined by below together with means as to how they are mitigated in this study:

<b>Factor</b>	
<i>Subject error</i>	This factor refers to measurement which may take place at different times may be subject to some bias and result in difference in results. Provided that the individual responses to the items are the same, mitigates the risk of subject bias.
<i>Subject bias</i>	The research subject giving you unreliable information because they think that telling the truth may example show them in a bad light. Consistency of information will be confirmed with responses throughout the questionnaire and the secondary data already gathered through the literature review process.
<i>Observer error</i>	Implies the bias that results from the different ways in which the interviewer can pose questions thus resulting in different results. Given that structured interviews will be used as the framework for asking questions mitigates the risk in the way and type of questions asked.
<i>Observer bias</i>	Refers to the way in which different researchers may interpret the same data in different ways, thus posing some form of bias in the findings and conclusions. Data

	analysis will be coded, thus standardising the outcome or results of the study given the answers provided by respondents to the identical questions posed in the structured interview.
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#### 4.6.4 Pre – Testing

Prior to conducting the formal interviews, the researcher held mock interviews with two colleagues in the investment space to fine-tune the research instrument (Wahyuni, 2012). “As a result, some expressions and words could be changed to make the questions clearer” (Wahyuni, 2012).

#### 4.7 Data Analysis

The analysis of structured interviews was qualitative with interviews used to ascertain whether non-financial information is indeed used by institutional investors in the decision-making process. A data analysis instrument of a computer aided qualitative data analysis software called ATLAS.ti was used to analyse the interviews.

Based on the data collected, the emerging dynamics that seek to mainstream the integration of ESG information into investment decision processes were retraced.

Saunders and Lewis (2012) outlined that, before capturing the data in the software, data was coded. To do this the researcher did the following:

- Determined the number of variables and gave them clear names.
- For each variable, worked out a coding scheme that will be collected using a questionnaire.
- Coded each variable leaving variables with no data blank.
- Set up data matrix.
- Checked data for typing errors.

To analyse factors deemed important by investor in sustainability reporting, an analysis of variance test was used in which average scores of the various elements of sustainability are collated and analysed to derive investor preferences as to which factors would influence their decision-making process in analysing non-financial reports for investment purposes.

## 4.8 Research Limitations

The research had the following limitations:

- i. Geographic limitations: the study only focused on private companies incorporated in the Republic of South Africa.
- ii. Investors: Investors were only be limited to institutional investors due to ease of accessibility. It thus excluded individual investors.
- iii. Non-financial information was limited to social, environmental and governance factors and exclude any of the sustainability initiatives of areas of interest.

## Chapter Five

### 5. Research Results

#### 5.1 Description of Sample

Investors can be institutional or individual (i.e. retail), and can also be referred to as asset owners. These investors are deemed to have different investment strategies, time horizons, and objectives (IFAC,2012) . Institutional investors, such as mutual funds, life insurance companies, and sovereign wealth, private equity, and pension funds, typically have longer investment time horizons than other investors because their liabilities to beneficiaries stretch over many years, they are also heterogeneous in terms of their investment style, time horizon, and investor base (IFAC, 2012).

A purposive sample of eight institutional investors comprising of analysts, portfolio managers, fund managers was interviewed at their place of work.

The sample obtained represents 53% of the identified research population and all of the interviews involved the individual responsible for institutional investments and where possible accountable for the ESG portfolio management in their organisation.

Depending on the location, interviews were conducted either telephonically or face to face for a duration of no more than an hour.

The interview outline in Appendix 1 was used for all interviews.

Question 1 – 3 in the interview outline were designed to obtain responses to question 1 and 2 in Chapter 3 namely;

#### Research Question 1

- Do institutional investors perceive that there is a correlation between non-financial reporting and the financial performance of the firm?

*Research question 1 aims to explore if investors perceive whether there is a correlation between non-financial reporting and financial performance of the firm. It is assumed that this is a factor that would influence the use of non-financial information in investment decision making process given the perceived value that this information will add.*

#### Research Question 2

- Do institutional investors use non-financial information in making investment decisions?

*Research question 2 cements the reason for the study of sustainable reporting, it will thus assess the capabilities of internal and external investment managers to incorporate ESG issues in their investment decision making process. As research has shown the vast availability and variations of this type of reporting but has not linked the use of this information for its intended purpose for investors especially value investors who take on a long term view.*

Interviewees were also asked what information they took into consideration when making investment decisions, factors presented in the question included risk, sector, environmental impact, IRR or returns, social impact, cost implications and or governance and sustainability requirements.

### Research Question 3

- If so, what aspects of non-financial performance influence the investment decision-making process?

*Research question 3 outlines the specific elements of non-financial reporting that investors would deem important in their decision making process thus aligning current reporting structures and frameworks to the demand investors currently have. It is expected that definitions will differ per individual and be of both an objective and subjective nature.*

Interviewees were asked to rank in the order of importance from high, medium and low, the ESG factors they would take into considering when making investment decisions. These factors included: resource management and pollution prevention, reduced emissions and climate impact, health and safety, labour relations management, community relations, corporate philanthropy, executive compensation, board accountability, shareholders rights and reporting & disclosure.

The interview questions were presented in a structured form but free flow was allowed to explore further themes that emerged from the interview. This particular method of exploratory research was appropriate as it allowed the interviewer to gather information that could be analysed through data mapping in answering subsequent research questions.

### Research Question 4

- Is the non-financial information currently provided to investors useful in creating value in the future, in light of competitive advantage derived from sustainability reporting?

*Research question 4 will explore the value derived once this information is available to the investor in the correct form, in a timely fashion and how this will assist the investor gain competitive advantage by applying principles of sustainability in their investment decision making process thus outperforming its peers in the market*

Subsequent question in the questionnaire from question 8 to question 10 were asked to derive the value of current sustainability reporting in creating value for shareholders as well as the impact of responsible investment being mainstream.

## 5.2 Research results

### 5.2.1 Definition of SRI in the context of your organisation and SA

Interviewees were asked to describe the criteria they applied in their investment decision making in the context of Social Responsible Investment in South Africa, as per the question posed to the interviewees, factors were categorised as follows:

- Risk
- Sector
- Environmental impact (high or low impact)
- IRR/ Return
- Social impact (high or low impact)
- Cost implications
- Governance and sustainability requirements

Of the eight interviewees three sighted risk as an important factor, three sighted sector specific and two for environmental impact as a factor taken into consideration when making an investment decision in the context of SRI.

Four interviewees sighted IRR / Return and social impact as a determining factor. No weightings were assigned across the various factors but ranking was limited to importance of the stipulated factor to the investor in their decision making process in the context of Social Responsible Investing.

Cost implications and government and sustainability requirements were only ranked as highly important by only one interviewee.

Additional factors identified over and above those categorised when posing the question deemed by interviewees to influence the investment decision making of investors included:

- Mandate of the company, (of which two interviewees highlighted as important);
- Valuation (which was sighted by two participants as a factor);
- The investees controlling stake/ minority position (which one investee emphasised) and ;
- Management skill (which was also picked up by one participant).

A distinction in the definition of Social Responsible Investing and Responsible investing had to be made to ensure that parties had a clear understanding.

Table 2 shows the percentage of respondents who ranked each factor in order of importance in their investment decision making process.

*Table 2*

<b>Information considered</b>	<b>N=8</b>
Risk	38% (n=3)
Sector	38% (n=3)
Environmental	16% (n=2)
IRR/ Return	50% (n=4)
Social Impact	50% (n=4)
Cost implications	13% (n=1)
Governance and sustainability requirements	13% (n=1)

### 5.2.2 Criteria applied in assessing investments for SRI performance

Interviewees were asked for the criteria applied in assessing investments for SRI performance. The criterion applied by each interviewee was subjective thus not weighting applied to it as it varied across interviewees.

Interviewee responses were classified as follows and not ranked according to any preference:

- Rating scale of A to C on ESG factors uncovered
- Mandate guided by existing system that linked pricing to developmental impact
- Legacy system focused on risk assessment
- Duration of mandates focused on internal allocations specified by mandate i.e. Job creation
- Quantitative impact given ESG factor
- Screening approach positive and negative
- Against criteria set by client

- Quality score
- Materiality
- Company specific
- Sector

### 5.2.3 Sources of non-financial information used in investment decision making process

Interviewees were asked to explain what their primary source of non-financial information was, the options presented were categorised as follows:

- Sustainability reports published by companies
- Internal research reports generated by experts
- Outsourced function to a service provider such as a sustainability consultant etc.

Of the eight interviewees questioned, the most common source of non-financial information was outsourced from various service providers. Two of the interviewees conducted ESG analysis and thus derived non-financial information as part of their due-diligence activities.

Only one responded quantified the split of his company would outsource versus what was generated internally. This participant identified a 70/30 split between what his company would outsource and what he as an analyst was responsible for generating as internal “intellectual property”.

Capacity constraint and lack of fundamental research on the topic we sighted as the major contributor to outsourcing the function of information gathering across all eight interviews.

Given the niche nature of this research, one participant sighted the type of service providers used as “bespoke research consultancies”. In addition one responded also sighted a limited number of players that can provide the service that can address ESG risk. Three service providers were identified as fit to provide this information.

Only two of the eight interviewees had specialised experts internally that could address this information need.

Other generic means of investor information identified included JSE SRI Index, Bloomberg and Reuters.

#### **5.2.4 Classification of ESG factors in order of importance**

Interviewees were asked to rank pre-selected ESG factors in the order of importance from high, medium or low as criteria applied when addressing ESG risk in the investment decision making process.

Factor presented to interviewees included and were limited to the following:

- Resource management and pollution prevention
- Reduced emissions and climate impact
- Health and safety
- Labour relations management
- Community relations
- Corporate philanthropy
- Executive compensation
- Board accountability
- Shareholders rights
- Reporting and disclosure

Table 3 shows the total percentage of respondents who deemed a certain ESG factor as either high, medium or ranked low in the order of importance in their investment decision making process.

Table 3

ESG Factor	Order of importance with respect to investment decision making		
	High	Medium	Low
	n=7	n=7	n=7
Resource management and pollution prevention	57% (n=4)	14% (n=1)	29% (n=2)
Reduced emissions and climate impact	71% (n=5)	14% (n=1)	14% (n=1)
Labour relations management	71% (n=5)	0% (n=0)	29% (n=2)
Community relations	71% (n=5)	14% (n=1)	14% (n=1)
Corporate philanthropy	38% (n=3)	14% (n=1)	43% (n=3)
Executive compensation	75% (n=6)	0% (n=0)	14% (n=1)
Board accountability	75% (n=6)	0% (n=0)	14% (n=1)
Shareholders rights	75% (n=6)	0% (n=0)	14% (n=1)
Reporting and disclosure	100% (n=7)	0% (n=0)	0% (n=0)

One interviewee failed to rank the issues in the order of importance citing reasons of the fact that not all factors would be relevant across all sectors. The interviewee currently uses a similar matrix which at the top lists sectors then lists all the different issues below that, in his view, not all ESG factors can therefore apply to a specific sector. The matrix used by the participant is modelled around a particular ESG issue, specific sector and asset class.

Sector specific was a common theme across all interviewees thus materiality of each factor was deduced on the basis of how common the particular ESG factor would feature in their investment decision making.

## 5.2.5 Asset allocation funds and integration of ESG into investment practices

Interviewees were asked to describe which asset classes currently integrated ESG into their investment practice, asset classes were categorised as follows:

- Large cap growth
- Large cap value
- Small / Medium cap value
- Short term bonds
- Long term bonds
- Mortgage backed securities
- Private Equity / Alternative assets

Four of the participants operate in the Private Equity space and fell outside of this criteria as they did not work with varying asset classes.

The remaining four interviewees cited Large caps as already incorporating ESG issues in their investment practices given that they already have better governance structures. One of the four interviewees cited understanding of ESG factors to support macro research across large cap growth and value as well as small cap value asset class. This responded lack of participation in the short term bonds as this was not a function that was carried out by his organisation. He noted that long term bonds are incorporated but done by a boutique firm within his group. Private Equity was also noted as a separate specialisation within the ambit of the group.

Across all four interviewees, the need to focus on and engaging smaller companies on these ESG issues was cited as a major concern due to their less sophisticated governance structures.

## 5.2.6 Implication of growing ESG awareness on mandate imposed on alternative asset classes

Interviewees were asked to unpack the implication of ESG awareness on the mandate imposed on alternative asset classes . All the participants identified that clients were the main drivers of the mandate of ESG being imposed on alternative asset classes.

Two interviewees cited Developmental Finance institutions (Dfi's) as one of the biggest drivers of this emerging trend with Pension funds also playing a critical role. Reasons cited were the government and developmental objectives of all Dfi's.

One of the interviewees also cited client education and awareness as a key driver of the emerging trend. Interviewees also saw this a growing trend irrespective of asset class as it is part of most mandates received from their clients including asset managers.

Participants view the investment environment as also shaping its self and gone with the growing wave of responsible investment. In all these cases the several interviewees highlighted the importance of the role that regulation such as King III and CRISA and regulators like the UNPRI have played and thus been identified as important milestones that have resulted in the shift or change in market perception toward the role of ESG factors in investment decision making.

## 5.2.7 Stakeholder engagement

All interviewees highlighted that stakeholder engagement is the cornerstone of communication of non-financial needs of the investor community. In general institutional investors are engaged directly. Interviewees will directly engage the relevant company responsible for the issue at hand i.e. remuneration issues would be addressed directly with the remunerations committee.

One interviewee applies a top-down approach in stakeholder engagement; this is to give guidance to stakeholders on ESG issues. Investee companies are provided with reporting templates and post investment expect an ESG officer to be appointed and to follow up with reporting requirements. As stakeholders, the company has information rights through their legal agreements. These also form part of stakeholder engagement post the investment. This was applicable to two participants.

Another interviewee also advised of the use of a standardised questionnaire in assessing ESG issues pre the investment.

As asset managers, the interviewee emphasised that their role is to manage the funds as per the mandate of the client. The interviewees' role is to engage clients and build capacity with internal stakeholders like staff as well. He sighted involvement in engagement at and industry level with regulators such as the FSB, Association for Savings and Investment as critical in addressing sustainability issues.

Feedback from management was however cited as a challenge as the relevance of the non-financial information provided by management was insufficient in addressing the investment community's information needs. In general, management was reluctant to feedback on this issue as there is currently a lack of measurement of current reporting measures. With no targets in place, this is viewed as something negatives thus the negative connotation by management.

## 5.2.8 Value creation creating for the shareholder through sustainability reporting

Two of the eight interviewees believe that sustainability reporting can create value for shareholders. The view is that the value is derived from risk mitigation derived from the incorporation of ESG factors in the investment decision making process.

One of the interviewees cited sustainability as fundamentally important in the competitive landscape of every single institution and business. Businesses that are able to articulate their value proposition on a broader scale other than shareholder value would be able to create a social license to operate on a continued market and source efficiencies which would be unpacked from sustainability information.

However findings still reveal that analysts do not factor ESG into their IRR.

Two participants did not believe that sustainability reporting has been able to create value for the shareholder at this stage.

Reasons cited are that, sustainability reporting has not yet been able to create value and could maybe do so in the long run. The analyst emphasise that although sustainability reporting assists investee companies in getting their affairs in order , it is still perceived as an administrative burden to comply with.

Other reasons cited include the fact that most financial analysts do not incorporate sustainability reporting into their valuation. The respondent links this to the usefulness of current reporting that does not engage nor quantify the risk but rather used as a marketing tool as opposed to a reporting tool.

### 5.2.9 SRI Mainstream

Interviewees were asked if SRI was in their opinion mainstream or not. Three interviewees disagreed, stating various challenges in making SRI mainstream in the investment environment. The first two participants identified perception by the investor community and society in general as a major barrier to making social responsible investment mainstream. Investors still have the perception sustainability reporting still involves a huge administrative burden. Another interviewee cited the misconception on the topic being the perceived sacrifice one would have to make on profits. This has given rise to limitations on SRI with respect to exclusionary screening constraining your investment universe. People have been resistant to change as environmentalists have been alarmists in the way they have communicated the state of the climate.

To mainstream it, the interviewee highlighted the growing awareness of regulation such as Regulation 28 goes a long way looking at values of institutions and value of institutions relative to retail investments. Thus by correcting the institutional part getting SRI to be mainstream will be achievable.

Others cited the challenge being more pressing at an individual level as opposed to at an institutional level where there has been more responsiveness and buy-in.

One interviewee described the hierarchy of SRI buy – in stemming from institutional level to High Net Worth Individuals to individual/ retail investor level.

High Net Worth Individuals are increasingly taking up the SRI initiative especially in areas like Europe, Germany, Scandinavia and some parts of America.

### 5.2.10 SRI in a South African Context

South Africa at an institutional level is leading because of changes in regulation and CRISA, from the perspective of interviewees is at par with the changes identified at an international level. Interviewees referred to examples of change and shift at a retail level as well with the

likes of Woolworths versus Pick n Pay which sells its organic offering at a premium, in the context to South Africa though; such has perpetuated the investor mentality that you have to pay more and sacrifice returns in order to follow sound ethical and sustainable practices. Interviewees viewed this as another barrier in changing this mind-set.

Upon comparing developed economies versus developing economies in the compliance requirements for sustainability reporting and practices, interviewees cited budget constraints as a challenge for emerging markets with respect to regulation around release of emissions and so forth. Given the lack of opportunity to grow at this stage, at a global level we will require collaborations and leadership in competitive guidance. Developments in this sphere are at a critical stage, thus a disinformation problem may arise as some are better positioned than others to benefit from this regulation. Policy will remain an issue affecting all of those with a short term focus and will affect the entire investment industry.

Thus cost is still viewed by participants as an important element for consideration. Looking at it at a granular level, compliance for corporate governance will still impact the emergence of sustainability reporting in South Africa.

### **5.3 Conclusion**

The results illustrated above will further be analysed in the following chapter in light of the literature presented in Chapter Two.

## Chapter Six

### 6 Analysis of Research Results

#### 6.1 Introduction

This chapter is aimed at bringing together key observations identified in Chapter Two, the Literature review as well as answer the research questions set out in Chapter Three. The results will therefore be discussed relative to the research questions posed.

#### 6.2 Analysis of Research Results

##### 6.2.1 Research question 1

*Do institutional investors perceive that there is a correlation between non-financial reporting and the financial performance of the firm?*

Only one participant that was interviewed perceives that there is a correlation between non-financial reporting and financial performance of the firm. Other interviewees do recognise the related value of non-financial reporting and value creation for the shareholder. The challenge cited by participants has been the ability to quantify the ESG factors thus deduce the perceived benefit that can be derived from it. As seen from analysis of Table 2, 50% of the interviewees took IRR and Returns as a factor in their investment decision making relative to SRI.

As cited in IFAC (2012) in Chapter 2, there are two major challenges with respect to co-ordinated efforts with respect to integrated reporting, firstly on whether ESG information is given credence by investors. Secondly is the fact that there is little consensus among investors and companies on key ESG investment criteria and how ESG information links to financial performance and long term sustainable success.

The relationship between ESG factors and financial performance of the firm has become increasingly important to investors.

Unpacking and quantifying ESG risk to derive the ESG scores can assist analysts track performance of companies relative to their estimates. Over the years the easier argument in this regard has been proving that there isn't a performance penalty subjected to ethical and socially responsible investing. Two interviewees have emphasised this as a misconception in the SRI space. Nonetheless, proving the positive correlation between SRI and performance of the firm has been the more difficult argument. This again can be linked to an argument presented by three of the eight interviewees that core of the problem is around the quality of non-financial information that is available.

Several analysts and fund managers interviewed stated that due to the above mentioned limitations, integration of ESG factors in their valuation model has been a challenge due to the challenge of "legacy systems which are unable to engage and quantify ESG risk". This finding is backed by literature examined in Chapter Two. The literature shows that over the last few years, there have been several coordinated efforts to encourage the integration of ESG into firm's valuation and investment making processes such as the Enhanced Analytics Initiatives (EAI) and the Principles for Responsible Investment. But until these ESG factors can be quantified, thus integrated into analysts' valuation models, the correlation between ESG and performance of the firm will be difficult to prove.

## 6.2.2 Research question 2

*Do institutional investors use non-financial information in making investment decisions?*

Two themes were identified with respect to Research Question 2:

- I. Information considered in making investment decisions
- II. Criteria applied in assessing investments

### **I. Information considered in making investment decisions**

Bourghelle et al., (2009) as cited in Chapter two reveals findings that dominant convictions could impede fund managers ability to integrate ESG information into investment decisions, external conventions related to collective behaviour found to be prevalent across the market whilst internal conventions that refer to conditions that are particular to and investment organisation like the team structure, culture, incentive system and attitudes towards SRI. Analysing responses derived from interviewees when asked to describe the criteria they applied in their investment decision making in the context of Social Responsible Investment in South Africa, as per can be seen in Table 2 majority of the interviewees deem IRR and Social Impact as the key factors to be taken into consideration when making investment decisions in the context of SRI in South Africa. Risk and Sector we ranked secondary to these two factors deriving the second largest percentage of 38% relative to other factors taken into consideration. This links in to findings revealed during interviews where respondents show signs of external conventions in their decision making, responses derived from the study indicate the point highlighted by respondents when asked whether SRI is mainstream in relation to the investor behaviour given the gaps identified in the usefulness of non-financial information currently reported.

An interviewee disagreed in that there are still challenges in making SRI mainstream citing the short term nature of the investor outlook given the organisational structure, culture and incentive schemes offered to the investor community the interviewee responded by saying "...I think it's not mainstream for two reasons; the one is because analysts is like it's something new so people don't think about it , they accept some certain stuff. And the other thing is that there is still quite a lot of short

termism in the market, we are measured quarterly, monthly so it's extremely difficult to get to a long term view if you are measure quarterly”.

Cost implications and government and sustainability requirements were only ranked as highly important by only one interviewee.

Additional factors identified over and above those categorised when posing the question deemed by interviewees to influence the investment decision making of investors included:

- Mandate of the company
- Valuation
- The investees controlling stake/ minority position
- Management skill

A study by Flostrand and Strom (2006) found that analysts tend to rely on forward looking non-financial information than historical non-financial information. This study finds that information has value and is deemed relevant by users if it is used by analysts in the valuation process, as an alternative form of measuring information usefulness. Thus policy makers and preparers of business reporting need to take into consideration that business reports now have to include information that is relevant in predicting future performance.

A study by Buzby (1975) as cited in Myburgh (2001) was conducted on 39 items of financial and non-financial information disclosed in annual reports and presented to financial analysts. The study revealed that a lot of items of information which analysts believed was important was not being adequately disclosed thus proved little correlation between the relative importance of items and the extent of their disclosure. (Myburgh, 2001)

## II. Criteria applied in assessing investments

From the responses gathered from the interviews conducted, interviewees identified a wide range of criteria that was applied in assessing the investments for SRI performance. Given that none of the respondents had a given and clear ESG investment policy many were guided by the mandates of their clients. Interviewee responses were classified as follows:

- i. Rating scale of A to C on ESG factors uncovered at due diligence stage
- ii. Mandate guided by the existing systems linked that link pricing to developmental impact
- iii. Materiality of ESG issues
- iv. Legacy systems focused on risk assessment
- v. Duration of mandates focused on internal allocations specified by mandate i.e. Job creation
- vi. Quantitative impact given ESG factor
- vii. Criteria set by client
- viii. Quality score
- ix. Sector
- x. Materiality
- xi. Company Specific

Investors typically have different approaches for assessing companies nonetheless there are similarities across the various investment approaches.

The three major approaches as outlined by one of the interviewees as follows:

- **Screening approach** : Which can entail Negative Screening approach whereby based on the investor values, investors “*screen out or do not invest in particular companies*” and is essentially based on particular values like “..not investing in alcohol, gambling, and tobacco;

- **Best in class approach** : Which is the type of investment where you are looking for those companies that are best in class in terms of ESG, disclosure practices and can be deemed to be quite similar to the screening approach;
- **Impact investing**: “When you are looking for not only financial returns but for environmental and sort of social benefits from the investment”.

As outlined in Chapter two, in addition to this Lusvarghi, V (2012) adds the following two RI strategies to the approach:

- **Engagement** : Which involves greater incorporation of ESG factors by shareholders and investee company that is derived through a dialogue between a shareholder and a company with the aim of improving the company’s value. This approach is more relevant for pension funds and other long term shareholders as a method to improve ESG outcomes.
- **ESG integration**: Integrating specific ESG information and criteria into financial valuation associated with a company.

Slager and Moon (2012) identified a number of limitations posed on strategies of investor approaches.

- Across the screening, engagement and integration strategies, ESG data was found not to be specific or in-depth enough for client demands. ESG data was not always relevant and up to date with company improvements.
- Integration strategies were also frustrated by the fact that data is not material for financial performance or was found to be only material for long term investments thus respondents also found it difficult to use it across companies as a comparative analysis over time.
- Engagement strategies were flawed by external ESG providers not holding any shares thus had little influence in the request for information.

As highlighted above, there are similarities between the criteria identified by interviewees and the literature.

### 6.2.3 Research Question 3

*If so, what aspects of non-financial performance influence the investment decision?*

Interviewees indicated that the factors that would influence their investment decision include:

- Resource management and pollution prevention
- Reduced emissions and climate impact
- Health and safety
- Labour relations management
- Community relations
- Corporate philanthropy
- Executive compensation
- Board accountability
- Shareholders rights
- Reporting and disclosure

From the list above they were asked to rank pre-selected ESG factors in the order of importance from high, medium or low as criteria applied when addressing ESG risk in the investment decision making process.

As detailed in Table 3, all factors the above factors were ranked highly with the exception of Corporate Philanthropy which a majority of 43% of interviewees ranked as low in the order of importance with respect to investment decision making. Another anomaly spotted in the findings was with respect to the Reporting and Disclosure factor which ranked highly amongst all interviewees attaining a 100% rate with respect to ranking highly amongst all interviewees.

Over and above the selection of factors presented to interviewees, the participants did not propose any additional factors outside this scope. In conducting the interview, prior to rating a specific factor, participants cited a major concern around the ranking

of ESG factors in the order of importance generically. Participants viewed this as a subjective of the ranking that should be contextualised relative to a specific sector. They felt that they could not generalise the relative importance of one factor over the other without specifying the context and sector to which their ranking would apply. Due to this challenge, it was thus difficult to quantify each factor with a percentage thus opted for a scale of high, medium and low importance.

One interviewee is quoted as substantiating their ranking as follows, “*it would depend on the sector , because what you want me to do is respond generally to you, therefore if it is important it would probably be something that would be taken into account in all cases*” . This finding is in line with work done by A4S as cited in Chapter two, the study identified that managers are rarely provided with the methodology and information need to make take into account the strategic sustainability objectives in a meaningful and robust manner. A4S thus developed a sustainability decision-making model to show how sustainability issues can be taken into account, part of the three part methodology explored the analysis of the life-cycle of particular products and services to determine the impact of key sustainability factors. This model also supports the view of sector specificity in consideration of sustainability issues.

From these findings, we can deduce that; relative to a specific sector, all ESG factors outlined in the selected list above are important factors, but again the relevance is limited to the context of the investment.

Only one interviewee could not rank the factors due for this very reason and was thus excluded from the population analysed in Table 3. Further comment was made that “*we must take a holistic view and cannot isolate any of these elements*”. One interviewee highlighted that the information considered would be sector specific as well as company specific, thus materiality would be important as any valuation done should take into account all material ESG factors to thus present an inclusive valuation. Earlier interviewees had cited the challenge of incorporation of ESG risk into their IRR due to the limitations presented by the challenge listed above. One of the implications is the continued exclusion of ESG risk in the pricing of investments.

The complexity of this matter will thus pose a challenge in identifying and generalising findings in deriving a model that can be applied by investors across the board.

In exploring the findings further , interviewees were asked to describe which asset classes currently integrated ESG into their investment practice.

Four interviewees cited Large caps as already incorporating ESG issues in their investment practices given that they already have better governance structures. One of the four interviewees cited understanding of ESG factors to support macro research across large cap growth and value as well as small cap value asset class. This participants noted that participation in short term bonds is limited as the function was not carried out by his organisation. He noted that long term bonds are incorporated but done by a boutique firm within his group. Private Equity was also noted as a separate specialisation within the ambit of the group.

Across all four interviewees, the need to focus on and engaging smaller companies on these ESG issues was cited as a major concern due to their less sophisticated governance structures. Given that interviewees insist on the relative sector of the investment, it would be important to understand the asset class that one is investing into.

#### 6.2.4 Research question 4

*Is the non-financial information currently provided to investors useful in creating value in the future, in light of competitive advantage derived from sustainability reporting?*

Ballow et al.,(2004) as cited in Chapter two eludes to the competitive advantage derived from sustainable reporting can be regarded as an 'intangible asset' which current accounting standards battle to quantify and measure. Executives therefore need to understand and see this benefit as it forms part of the components of future value.

One of the interviewees cited sustainability as fundamentally important in the competitive landscape of every single institution and business. Businesses that are able to articulate their value proposition on a broader scale; other than shareholder value would be able to create a social license to operate on a continued market and source efficiencies which would be unpacked from sustainability information thus used to create value for shareholders in the future.

Contrary to this belief another interviewee perceives that a lag in realisation of this value is mainly caused by the fact that SRI lacks the buy in and is not mainstream amongst relevant stakeholders such as financial analysts whom do not incorporate it into their valuation. This argument is linked to the debate around the usefulness of the type on non-financial information currently generated by companies to meet the investor community's information needs. Interviewees have highlighted the fact that current reporting does not engage ESG risk given the perception that current reports are a marketing tool for companies rather than a reporting tool. De Klerk and De Villiers (2012) study revealed that information symmetry between shareholders and managers of the firm influences the shareholders' risk assessment of a company, thus concluding that it is not sustainability reporting alone that causes the level of market value, but that investors use non-financial reporting together with other relevant sources of investment data to value a company stock. Thus non-financial reporting can be regarded as 'value-relevant' in investment decision making .(De Klerk and De Villiers, 2012).

Two participants did not believe that sustainability reporting has been able to create value for the shareholder at this stage.

Reasons cited are that, sustainability reporting has not yet been able to create value and could maybe do so in the long run. The analyst emphasise that although sustainability reporting assists investee companies in getting their affairs in order , it is still perceived as an administrative burden to comply with.

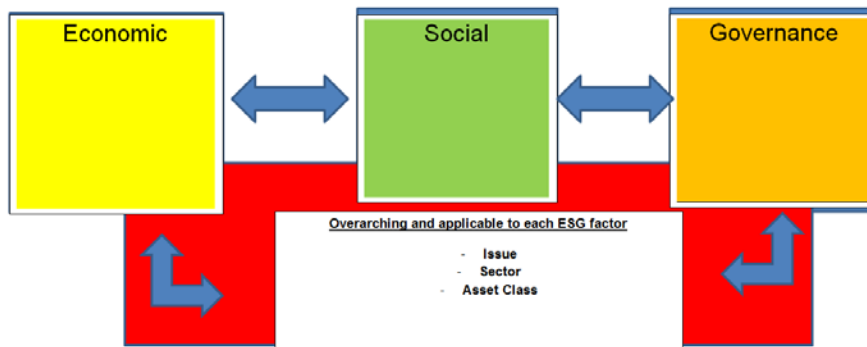
### 6.3 Model of research results

The only way in which a model can be derived is by ensuring it is as generic thus applicable to all aspects.

This cannot be achieved as each ESG factor is unique in the Issue to be addressed, the Sector and the Asset class applicable.

As outlined in Figure 1, these three factors have to be taken into account when screening any factor to be taken into account in the investment decision making process.

Figure 1: ESG Model proposed to quantify ESG factors and assist in making investment decisions



## Chapter Seven

### 7.1 General conclusions

It can be concluded from the research enclosed that institutional investors do integrate non-financial information in their investment decision making, but as to how important a role that this information plays in the investment decision making process is relative.

The study show a correlation between sustainability in the long run and financial performance of the firm but lacks to quantify the impact of the non-financial reporting relative to this performance. Thus a business case can be built around sustainability provided suppliers on non-financial information can quantify the ESG aspects. Various ESG factors are deemed important but still relative to specified sectors and can only derive benefit if viewed in context of a sector, particular risk to be addressed, availability of information and usefulness of the available information in making investment decision.

By applying the learning's in Chapter Six, institutional investors can identify factors that can be modelled in understanding, quantifying and integrating ESG risk in their investment decision making.

Thus for sustainability to be mainstream the investment community needs to be met by information that is relevant, timely and consistent in a form that is understandable to users.

Regulation has played an important role in enhancing the stance of integrated reporting, although not mandatory a growing phenomenon amongst the investment community. But for sustainability reporting to become mainstream regulators need to gain more leverage and non-compliance should be met with punitive measures.

Interviewees also highlighted the need for some form of measurement to be effected and made mandatory in the reporting requirements of companies. Stakeholder engagement especially that of the asset consultant community is a critical area to be addressed, as these gate keepers that are the link between people with money and people that manage money are a critical joint in the investor equation. Buy – in thus use of current reporting measures by these stakeholders will symbolise another stepping strong in mainstreaming SRI.

Like any other factor, institutional investors play an important role in mainstreaming SRI as it would be difficult to enforce regulation on individual and retail investors. Emerging trends for emerging countries such as South Africa can be observed through research conducted in Europe where the mainstreaming of SRI commenced at an institutional level, and filtered down to individuals through high net worth individuals and ultimately retail investors.

Useful information can assist investors in meeting their information needs in a timely, consistent and reliable manner. The research shows that there is no clear cut model in which investors apply non-financial information in making investment decisions and that in many cases these considerations are subjective. Thus how do regulators, institutional collaborations through institutions like CRISA, the UNPRI play a role in addressing this need continuously building capacity and awareness in the investor community around sustainability? People to date still misconstrue responsible investment as having to forgo returns in order to comply; this is not the case thus the reluctance of many analysts as revealed by the study to incorporate ESG findings into their valuation methodology.

Stakeholder engagement is also critical as sustainability requires a long term view matched with long term investment philosophy, but given the structure of the investment industry, possess a challenge in consistently behaving in this manner. The study reveals that to date shareholders reward the investor community through short term measures like performance bonuses, dividend structures etc.

## 7.2 Implications for institutional investors

Clearly a business case does exist for sustainability reporting and institutions can gain competitive advantage through aligning their activities and outlook in a sustainable manner. The role of institutional investors is thus critical in laying a foundation to mainstream SRI.

From a South African perspective this will play an integral role in alleviating current social disparities and inequalities, through partnerships also alleviate the challenge of government lag in service delivery.

Business must come to the forefront in this proposed partnership and play its role of the corporate citizen.

### **7.3 Implications for investor community**

The growing trend of sustainability and SRI presents an opportunity to build further capacity at an individual / retail investor level. Given the benefits derived by shareholders from RI, a win-win scenario can be attained by all parties. As citizens, investors are also deemed responsible for the impact on the planet and need to play a role in addressing environmental, social and governance issues through their collective power.

### **7.4 Recommendation for future research**

This study attempted to identify some of the basic ESG factors that would impact the investment decision making process of institutional investors. It outlines the available resources and demand for non-financial information in that regard.

Through the various themes that arise, several avenues for future research can be proposed to build on findings of this research:

- How can the accounting profession create awareness in ESG reporting and its role in mainstreaming ESG practices?
- ESG KPI's used by institutional investors thus resulting in the measurement of current ESG practices.

- Mandates imposed on institutional investor across emerging and developing countries and the resultant impact of prevalence of SRI in that country.
- Comparatives of actively managed SRI portfolio and the existence of ESG policy that would govern investor practices.

## 7.5 Conclusion

This research identified the main ESG factors that institutional investors deem important in their investment decision making. Following which providing a standardised guideline for the investor community including compilers of integrated reporting to meet the users' needs. The proposed model needs to be further refined and drilled down to meet the sector specific needs of the users. This research thus contributes to an initial contribution to an under researched area that has not been addressed.

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## Appendix 1 – Interview Outline

Interview guideline	Questions/ Statements to be posed
Part 1 of interview	
<p><b>Introduction and background</b></p> <p>Thank you for your time and input</p> <p>Please read through the interview consent form which was sent to you on confirmation of this interview and complete it before we start.</p> <p>I would like to confirm the confidentiality of the data I collect from you. If required, this interview can be anonymous and your name and/ or company name will not be reflected in the research report.</p> <p>The title of this research is “Growing Investor Demand for Non- Financial Information”</p> <p>The key objectives of this research are to;</p> <ul style="list-style-type: none"> <li>▪ Assess the current non-financial reporting structures and whether this information is used by investors in making investment decisions.</li> <li>▪ Explore which of the key elements of sustainable reporting that will influence the investment decision making process of an institutional investor.</li> <li>▪ Assess how non-financial information currently reported by corporations creates value for the firm in the future in light of the competitive advantages derived from sustainability reporting</li> </ul> <p>The interview will be conversational and exploratory. I would like to encourage you to speak freely and openly, and not be limited to just answering the research questions.</p> <p>In this study, I have defined the key terms as follows:</p> <p><b><i>Institutional investors</i></b> are defined as “specialised financial institutions that manage savings collectively on behalf of small investors towards a specific objective in terms of acceptable risk, return maximisation and maturity of claims”. For the purposes of this study, the sample institutional investors will be limited to institutions such as asset and fund managers, research analysts, investor</p>	

relations officers and portfolio managers. Government, individual/ retail are therefore excluded from this study.

**Non-financial information:** For the purposes of this report the term ‘non-financial’ has been selected as an overarching term to describe and explain social and environmental issues. For the purpose of this report it has been selected as a suitable umbrella term. Within this study, the terms non-financial and sustainability shall be interchangeable.

**Sustainability reporting:** A sustainability report is an organisational report that gives information about economic, environmental, social and governance performance.

**Objective:** The ultimate purpose of this research is to gain insights into the non-financial information requirement of investors and how this information can be implemented in the investment decision making process of institutional investors to create sustainable value in the long run.

Before we start with the interview, do you have questions?

**Part 2 of interview**

- |  |   |
|--|---|
| <ul style="list-style-type: none"> <li>• No more than 10 open-ended questions</li> <li>• Ask factual before opinion</li> <li>• Use probes as needed</li> </ul> | <p>Questions as per draft questionnaire</p> |
|--|---|

**Part 3 of interview**

- |  |  |
|--|--|
| <p><i>Closing Key Components:</i></p> <ul style="list-style-type: none"> <li>• Additional comments</li> <li>• Next steps</li> <li>• Thank you</li> </ul> | <p>What recommendations do you have for future efforts such as these?<br/>Is there anything more you would like to add?<br/>I’ll be analysing the information you and others gave me and submitting a draft report to the organisation in two months. I’ll be happy to send you a copy to review at that time, if you are interested.<br/>Thank you for your time.</p> |
|--|--|

## 12. Appendix 2 - Questionnaire

	Questions	Comments
1	In the context of SRI in SA, what information do you consider in making investment decisions? <ul style="list-style-type: none"> <li>- Risk</li> <li>- Sector</li> <li>- Environmental impact (high or low impact)</li> <li>- IRR/ Return</li> <li>- Social impact (high or low impact)</li> <li>- Cost implications</li> <li>- Governance and sustainability requirements</li> </ul>	
2	How did you determine the range of criteria to be applied in assessing the investments for SRI performance	
3	What is your primary source of non-financial information used in your investment decision making process: <ul style="list-style-type: none"> <li>- Sustainability reports published by companies</li> <li>- Internal research reports generated by experts</li> <li>- Outsource function to a service provider such as a sustainability consultant</li> </ul>	
4	Rank the following ESG factors on a scale of 1 to 10 with 10 being the most important factor	
	- Resource management and pollution prevention	
	- Reduced emissions and climate impact	
	- Health and safety	
	- Labour relations management	
	- Community relations	
	- Corporate philanthropy	
	- Executive compensation	
	- Board Accountability	
	- Shareholders Rights	
	- Reporting and disclosure	
5	Describe the asset allocation funds that currently integrate ESG into practices according to the list below	
	Large cap growth	
	Large cap value	
	Small/Mid cap Value	
	International developed growth	
	Short term bond	
	Long term bond	
	Mortgage backed securities	
	Private Equity / Alt assets	
6	What implication has the growing trend in ESG awareness had on the mandate you impose on alternative asset classes such as Private Equity?	
7	How do you engage your stakeholders on sustainability issues?	
8	Does current sustainability reporting create value for your shareholders, if so how?	
9	Why in your opinion is SRI mainstream if not, elaborate as to the reasons why?	
10	Is there anything else you would like to add to the topic?	

