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2013 ESG Trends to Watch

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If there is one thing that Hurricane Sandy in the US taught us, it is that preparation counts.

What seemed unlikely even just a day before the storm upended business-as-usual and reinforced the primacy of risk management. Identifying vulnerabilities, however, requires challenging core assumptions about what past data and experience can tell us in the face of the unexpected. As MSCI ESG Research looks forward to 2013, we see clouds on the horizon in the context of accelerating climate change and populist disenchantment in key emerging markets with the way business gets done. Yet, those who look beyond the constrained horizons of stagnating home markets and business-as-usual to retool their strategies for new growth drivers have the chance to seize a significant first mover advantage. As growing risk awareness propels investors to seek long-term bets that will sustain them through the next storms and upheavals, these far-sighted companies will gain momentum over the complacent.

1. **Waiting For The Storm**

   What if Hurricane Sandy came every year, to a financial capital near you? Companies on the MSCI World Index have located significant fixed assets in climate-vulnerable areas.

2. **Bottom of the Pyramid and Top of the Pack**

   Sluggish economic growth and regulatory and fiscal constraints will push companies in healthcare, consumer, and other sectors to seek growth in underserved market segments. Yet, the opportunities remain largely unexplored.

3. **What Health & Safety Metrics (Don't) Tell Us**

   To uncover the next BP, relying on health and safety metrics alone is not enough. Failing to factor in the geographic and industry context obscures the hidden risks that could precipitate the next disaster.

4. **Protesting Corruption**

   Public outrage over corruption has pressed governments in China, India, and Russia to pursue an anti-corruption agenda. Companies most prone to being implicated in corrupt practices have largely failed to shore up their ethics practices.

5. **Meaningful Data and the Movement of Markets**

   There is evidence that signs of improved risk management on ESG issues are being rewarded in the equity market. But while companies have improved their reporting on ESG issues, they often report on issues where they face little financial impact while ignoring issues that pose significant risks to their core businesses.

1. Waiting for the Storm

Despite the heavy human toll, unprecedented infrastructure damage, and lost productivity, economists agree that the cost of Hurricane Sandy will likely be absorbed by the US economy without substantial negative impact on GDP growth.

But what if Sandy came every year, to a financial capital near you?

Recent talks at the UN Convention on Climate Change in Doha have refocused the spotlight on the vulnerability of poorer countries to the effects of climate change. Because places such as Haiti, Bangladesh, and Zimbabwe top the list of countries that are most vulnerable to climate change, investors have paid relatively little attention to the vulnerability of their major assets to catastrophic weather events.

But in fact, a significant share of assets located in developed markets is at high risk for weather-related disasters.

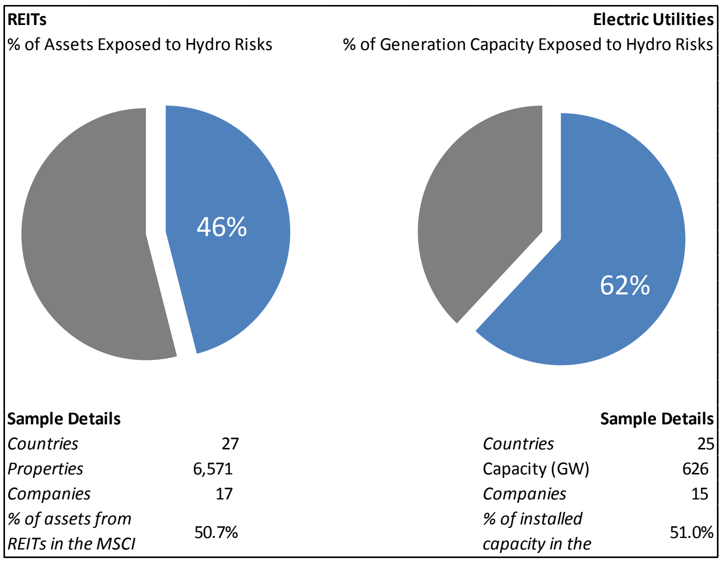

Figure 1: Percentage of Assets Locate in Areas Prone to Hydro-Related Risks

At the country level, as part of MSCI ESG Research's Sovereign Ratings research on the long term risks that countries face from their natural resource, social capital, and institutional characteristics, we have evaluated the vulnerability of 90 countries to environmental disasters and natural hazards.

Two-thirds of the Developed Market countries are deemed to be either Highly or Extremely Vulnerable to damage by natural hazards, according to data from the Environmental Vulnerability Index[1], compared to about half of the countries classified as Emerging or Frontier Markets.

[1] EVI is developed by South Pacific Applied Geoscience Commission (SOPAC), the United Nations Environment Programme (UNEP) and their partners (http://www.vulnerabilityindex.net/EVI_Background.htm).

At company level, our analysis shows that ***companies on the MSCI World Index have located significant fixed assets in climate-vulnerable areas***:

- We mapped the installed capacity of the 15 largest Electrical Utilities companies in the MSCI World Index, which collectively serve an estimated 188 million people across Europe, US, and Japan. We find that ***62% of the aggregate installed capacity is located in areas vulnerable to floods and cyclones.***
- We estimate that ***approximately 46% of the assets held by the 17 largest REITs are located in areas prone to flooding and cyclones***, as defined by the World Bank and the Center for Hazards and Risk Research at Columbia University. The 6,571 properties in these companies' portfolios are located in 27 countries and comprise just over 50% of property assets of REITS in MSCI World Index.

As climate change exacerbates the intensity and frequency of extreme rainfall and raise sea levels, investors will need to brace for economic disruptions and the kind of large scale damage to property and infrastructure that could significantly impact asset values in developed markets around the world.

2. Bottom of the Pyramid and Top of the Pack

Sluggish economic growth and downward pricing pressure driven by regulatory and fiscal constraints will make core developed markets increasingly tough terrain for a number of industries. Longer term, growth will be determined by companies' ability to tap underserved demographics both domestically and abroad.

Despite a lot of lip service paid to the commercial potential of demographic shifts and 'bottom of the pyramid' strategies, the opportunities remain largely unexplored even for sectors facing strong headwinds in their existing markets. In the healthcare industry, for example, unsustainably high healthcare costs in the US will push down drug prices in the long term for pharmaceutical companies already being hit in the short term by the 'patent cliff,' when top-selling drugs lose patent protection.

The imperative to re-strategize for new markets is clear. Yet, our analysis shows that ***the top 15 global pharmaceutical companies derive less than 6% of their aggregate revenues from the fastest growing but underserved markets.*** The 20 fastest-growing economies in the world have experienced average GDP growth of 9.9% over the past five years and currently spend only about 6% of GDP on healthcare.

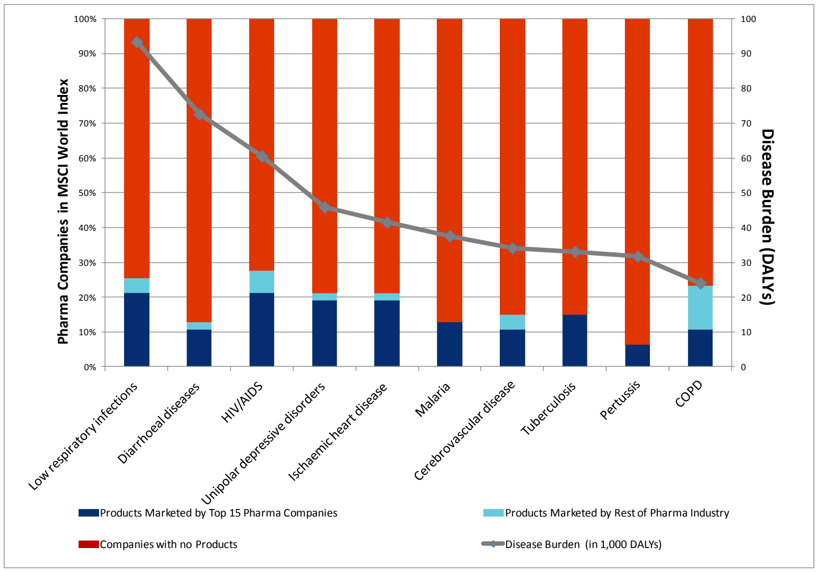

Figure 2: Percentage of Pharmaceutical Companies in the MSCI World Index Offering Products Targeted at Top Ten Diseases

As the largest pharmaceutical companies – both brand name and generics producers – adjust their business models toward higher volume/lower price strategies that align better with longer term secular growth trends, opportunities for both market growth and social impact are substantial.

Similar to analysis that MSCI ESG Research has conducted on behalf of the Access to Medicines Foundation, our analysis of the current products addressing the 'Top Ten Diseases'[2] in developing countries shows that these pressing diseases continue to be largely underserved. ***In fact, only a handful of companies have offered commercial products addressing these Top Ten Diseases*** (see Figure 2). Hypertension alone is projected to afflict 1 billion people in developing countries by 2025; currently, only four companies on the MSCI World Index offer products to address this growing market.

Products and services targeting the underserved segments in healthcare, consumer, banking, and telecommunications continue to be treated by the vast majority of companies as philanthropic endeavors with little commercial pay off rather than serious, long-term strategic bets. The ability to differentiate these companies from the handful of first movers that are systematically building distribution channels and developing products for high growth, underserved markets will put investors in a strong position to ride the next big wave of market growth.

3. What Health & Safety Metrics (Don't) Tell Us

In the wake of BP's record breaking criminal fine resulting from the Deepwater Horizon accident, investors have been paying increased attention to health and safety metrics. Because BP's H&S track record lagged prior to the blow up, there is increasing faith that these metrics can provide an early warning signal to potential tail risk events.

But in fact, the usefulness of H&S statistics as a forward-looking signal is highly reliant on understanding the industry and geographic context in which these statistics are produced. ***Injury rates, in particular, tell investors very little unless the norms and standards for reporting are factored in, along with qualitative analysis of specific incidents.***

In our annual benchmarking of H&S trends for sectors prone to accidents, we find that while injury rates have declined over the past four years for companies in Oil & Gas, Metals & Mining, and key industrial sectors such as Steel, companies with substantial operations in Emerging Markets have in fact experienced an uptick in fatality rates.

- In the mining sector, for example, companies with reserves predominantly in Developed Markets show both decreasing injury rates and worker fatality rates over a four year period, while companies with significant reserves (more than 70%) in Emerging Markets reported decreasing injury rates while experiencing increasing fatality rates.
- Similarly, although Emerging Markets steel companies report both lower injury rates and larger declines in injury rates over the past four years, compared to their Developed Market counterparts, the average fatality rate is in fact almost four times higher than for Developed Market peers (see Figure 3).

[2] Overall Disease Burden in developing countries as measured by DALY, or Disability Adjusted Life Years.

Figure 2: Percentage of Pharmaceutical Companies in the MSCI World Index Offering Products Targeted at Top Ten Diseases

This dynamic is explained through a combination of looser standards for reporting injuries in some Emerging Markets (what constitutes an injury is certainly more subjective than what constitutes a fatality) and stronger safeguards in Developed Markets to prevent mishaps from turning fatal, as well as differences in worker skill levels that would drive some Emerging Market operations to experience more serious accidents relative to Developed Market operations.

Hence a critical component of our assessment to uncover hidden risks that could precipitate the next disaster is a ***systematic analysis of the frequency and severity of historical incidents, fines and penalties that often go unreported by companies*** and are found through third-party sources, such as press, regulatory filings and evidence from NGOs. Among Integrated Oil and Gas companies, for example, we find that for companies with the most problematic track records, plagued by frequent and severe accidents such as BP, Gazprom, Petrobras, and PetroChina, injuries or fatalities in isolation tell an incomplete story.

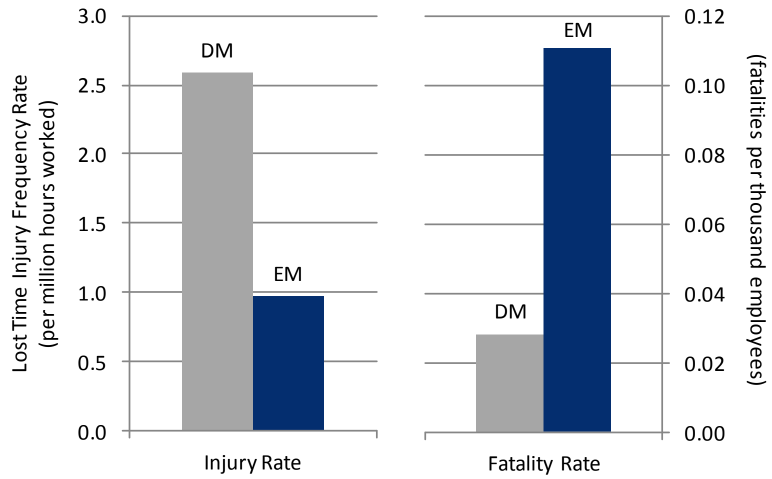

Figure 3: Injury and Fatality Rates of Steel Companies, Developed Markets versus Emerging Markets

For investors seeking warning signs of impending accidents, tracking reported statistics on H&S is not enough. To uncover the next BP, H&S statistics need to be critically evaluated for the context and scope of reporting and amply augmented by a thorough review of specific incidents to identify the harbinger for future operational disasters.

4. Protesting Corruption

It's not exactly Arab Spring, but the size, scope, frequency, and intensity of mass protests in China have risen dramatically in the past several years, culminating in a number of high profile protests this year that have aborted plans for new industrial plants. At the heart of China's social discontent is first and foremost a growing intolerance of corruption and concerns about growing inequality. According to the 2012 Pew Global Attitudes Survey, 50% of China's respondents cited corruption as a 'very big problem,' more than any other concern.

To preserve social stability especially in a sensitive period of political transition, newly elected leader Xi Jinping at the first Politburo meeting called for a major program to fight corruption, which if unchecked could 'kill the party and ruin the country.'

The public mood against corruption appears to be infectious:

- In India, anti-corruption sentiments that were given voice last year by activist Anna Hazare through mass demonstrations and hunger strikes, and Arvind Kejriwal, who launched a political party last month on an anti-corruption platform, have put the government on the defensive. Scandals involving mobile spectrum allocations resulted in revoked licenses for key telecom players; recent accusations over mis-allocation of coal blocks have similarly implicated top Indian companies including Tata Steel and Jindal Steel.
- In Hong Kong, as many as 400,000 protestors demonstrated in July to air grievances on social issues, including perceived collusion between government and business elites. Worries about resurgent corruption has put a spotlight on the Independent Commission Against Corruption (ICAC), which enhanced its credibility with the public this year through high profile cases including the arrest of the city's number two government official.
- Even in Russia, Putin has recently signaled an anti-corruption campaign to shore up support among a public that has become deeply skeptical of a system perceived to condone widespread corruption in business dealings and civic life.

Whether these shifts in policy focus result in sweeping structural changes or simply in a wave of high profile prosecutions, for investors, it should augur a serious look at companies and sectors vulnerable to being targeted for corrupt practices. There are two ways that any upcoming corruption sweeps could impact investors: (i) through an immediate hit to a single stock or (ii) a longer term attrition of competitive advantage through lost political access.

In the first case, exemplified this year by cases such as Sun Hung Kai, the headline impact can be large (15% in one day for Sun Hung Kai), but it is the second case whereby the removal of top officials or delay in permitting that can have larger cumulative impact on growth and competitiveness. The arrest of a top official in the Railway Ministry in China, for example, contributed to a 35 percent cut in railway investment in 2011 from 2010, continuing into slow spending in 2012. New bidding procedures introduced in recent months use third party experts to evaluate tenders rather than rely on political ties to allocate projects, potentially eroding the pipeline of future contracts for some infrastructure players.

Among companies we assess to have the highest susceptibility to corrupt practices in the MSCI All Country World Index – based on share of revenues from government contracts and prevalence of bribery in their core business activities and geographic areas of operation – ***over one-third of the 283 companies we see facing the highest risk exposures currently lack any strategy to ensure integrity of business conduct throughout their operations***. Of the companies that appear least prepared to tighten the ethical reins, 40% are based in India, Russia, and China and concentrated in heavy industry, extractives, real estate, and banking.

As these governments attempt to appease populist outrage and shore up political support through an anti-corruption agenda, companies where corruption might be 'business-as-usual' could pose significant risk for investors who ignore the evolving social and political context in key markets.

5. Meaningful Data and the Movement of Markets

According to Institutional Shareholder Services Inc. (ISS), more than 20% of shareholders voted 'yes' on proxy proposals last year involving Environmental and Social issues, an increase from 7.6% in 2000 and 9.8% in 2005. As investors and stakeholders groups put pressure on companies to increase their attention to ESG issues, company reporting on these issues has been on the rise. But does the improved disclosure help investors gain insight into companies' risks and opportunities, and how can it help them make better investment decisions?

Because companies are under pressure to address a wide variety of issues of concern to various stakeholders, ***they are often reporting on issues where they face little financial impact while ignoring issues that pose significant risks to their core businesses.***

- For example, more than 60% of MSCI World companies have reported their carbon emissions in some form over the past three years. Yet, according to our analysis, ***the percentage of companies in an industry reporting on carbon emissions bears only a mild relationship to the relative carbon intensity of the industry's core business activities*** (see Figure 4). Although insurance companies are among the least carbon intensive businesses according to our data, 67% of MSCI World Index insurance companies reported on their carbon emissions, compared to only 55% of airlines, which are on average the most carbon intensive businesses.

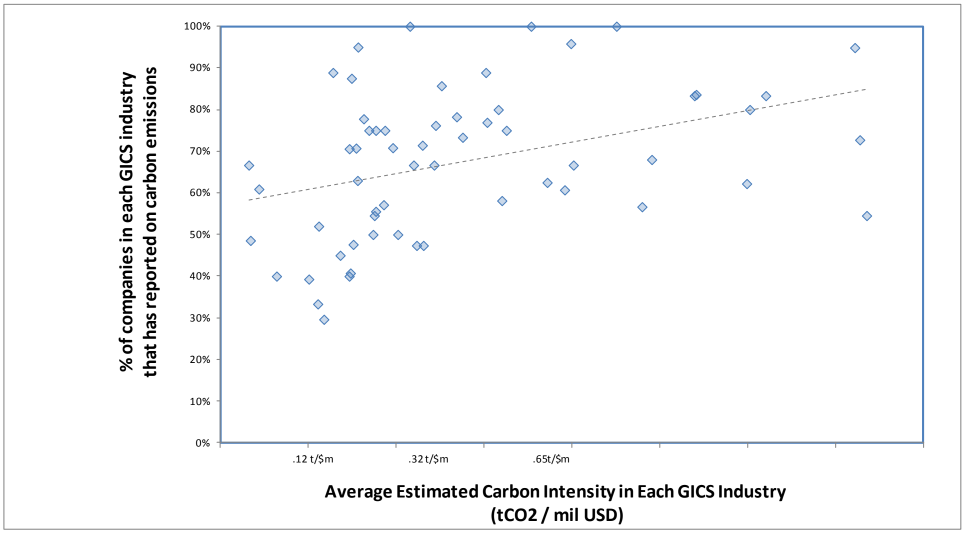

Figure 4: Average Carbon Intensity and Percentage of Companies Reporting on Carbon Emissions, by GICS Industry

- Conversely, on the operational risks arising from water stress, although our analysis estimates that roughly 200 companies in the MSCI World Index are operating in water intensive industries that are located in high water stressed regions, among those companies, only about 90 companies have any programs in place to manage water efficiency and mitigate water-related operational disruptions.

Hence, while companies may be reporting more and on more issues, there continues to be a major gap between where companies face the greatest operational and financial risks in their core business and their strategies and track record on managing those risks.

To the extent that some companies narrow the gap between their high exposure to the few, material ESG-driven risks and their ability to manage those risks, ***there is some evidence that signs of improved risk management are being rewarded in the equity market***. In a recently released study[3] that analyzed MSCI ESG IVA's company ratings using Barra's Global Equity Model (GEM3), the authors found that a portfolio overweighting companies that improve their ESG rating over the period from 2008 to 2012 achieved better returns relative to the benchmark portfolio (see Figure 5).

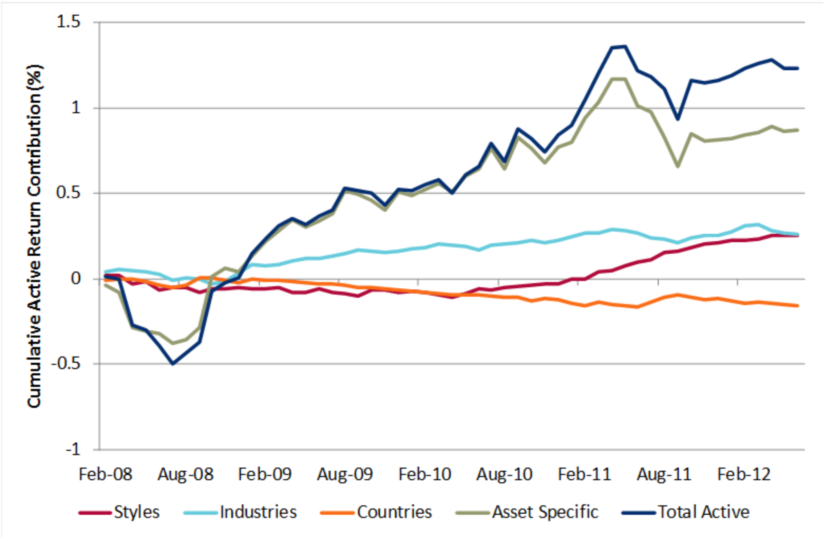

Figure 5: Return Decomposition of ESG Momentum Strategy, February 2008 – June 2012

As investors pay more attention to the longer term macro risk drivers in their portfolio, they will demand that companies, too, demonstrate a greater capacity to identify and close those key gaps in managing their long term risks. Companies that get there first will reap advantage, both in their appeal to investors and in their own operations.

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[3] Zoltan Nagy, Doug Cogan, and Dan Sinnreich. Optimizing Environmental, Social, and Governance Factors in Portfolio Construction: An Analysis of Three ESG-tilted Strategies. MSCI ESG Research, Insights Whitepaper, December 2012.

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