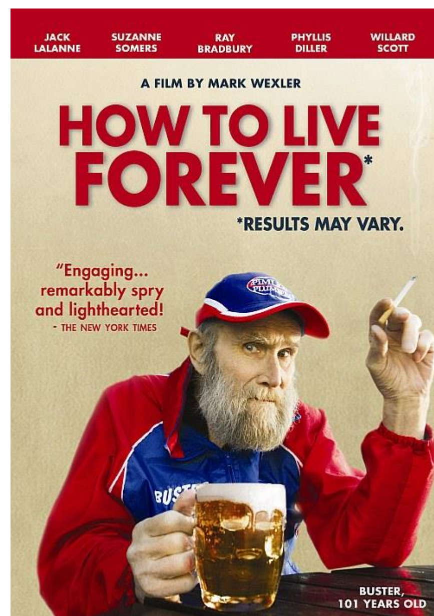

Centenarian Chain Smokers

LESSONS ABOUT THE PREDICTIVE AND EXPLANATORY VALUE OF ESG RESEARCH

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Meet Buster

If you watch director Mark Wexler's *How to Live Forever*, you'll see that a chain-smoking, beer-drinking centenarian makes a great character in a documentary film. But this biological oddity hardly qualifies as a role model for people who want to live long and healthy lives. Indeed, some studies have found that a surprising number of centenarians smoke, drink and live dangerously. Yet, most scientists and laymen would agree that they can best extend the years of their lives (and, yes, the life in their years) by not smoking and not drinking.

In our view, the same logic applies to the integration of environmental, social, governance (ESG) and forensic accounting research into the analysis of investment risk. For the most part, this expansion of traditional approaches to investment analysis is continuing steadily. But we still see some evidence of lingering resistance to this inevitability. Here, we'd like to address some of the misconceptions that fuel this resistance. No doubt, these misconceptions are weakening and receding from the forefront. Still, we'll offer a few observations here to help speed their passage to the dustbin.

Corporate character matters. There's value in values. Ignoring values can destroy value.

ESG and forensic accounting have already moved the financial community toward a healthier, humbler and more holistic understanding of risk. Investors, insurers and other market participants are employing "extra-financial" research in part because they see that it can help them improve performance, whether it's the performance of an equity portfolio, a D&O insurance policy or a fixed-income strategy.

Over the past year, we published broad-ranging research findings that corroborate this claim. Bob Monks' upcoming book will bring fresh ideas to this growing body of research. Still, we occasionally hear dismissive arguments that challenge the relevance of non-traditional research.

True, the critics say, ESG risk metrics may capture aspects of corporate behavior that deviate from purist notions of justice, equity and fiduciary duty. But how materially do these departures from ideals really affect performance and profit? After all, some of the ESG anathemas — e.g., dual-class shares, combined CEO/Chair positions, rewards for failure, ignored shareholder votes — are so common. Should we really get worked up about these bugbears?

At earlier stages in the evolution of ESG research, this question might have resonated more broadly. Back then, ESG still focused on values more than value. It treated the two goals as mutually antithetical. GMI has long distinguished itself by focusing on the value of values. From this vantage point, here's what we've found that should change the mind of any reasonable skeptic:

Between 2005 and 2012, a portfolio of companies with top-decile Accounting and Governance Risk (AGR®) ratings would have outperformed the lowest-decile portfolio by 123% in North America, 74 % in Western Europe, 94% in Asia Pacific (ex. Japan) and 128% in Japan.

In GMI Ratings' Litigation Risk Model, the majority of companies facing Federal class-action lawsuits are consistently ranked in the lowest 20% of the risk ratings distribution a year before these lawsuits were filed.

In a heuristic study of 36 of the largest CDS defaults ever, companies in the bottom AGR decile were 11 times more likely to default than companies in the top AGR decile using a 6-12 month look-back period.

In a 2012 study of North American companies with market caps of more than $20 billion, we found that 5-year total shareholder returns were nearly 28% higher at companies with separate Chair/CEO roles.

Companies with bottom-decile AGR ratings experienced major price drops (70%+) 3.6 times more frequently compared to companies with top-decile AGR ratings.

Based on forensic accounting measures, we recently alerted investors to the elevated risk of major share drops in companies such as HP, Caterpillar, and Chesapeake.

Risk Modeling vs. Prediction

Risk modeling is not prediction. The former is an earnest attempt to make thoughtful decisions in the context of complex uncertainty. The latter is a centerpiece in Wall Street's media-fueled culture of "propheteering".

We see mounting evidence about the relevance of ESG/AGR research to the decisions of all market participants exposed to investment risk. But this research also invites questions about "false positives," companies that perform well despite their poor ESG or accounting ratings. The simple answer to this question is to acknowledge the obvious: no one knows the future. No statistical risk model works perfectly — not in finance, or medicine, or economics or any area of life ever scrutinized through the prism of statistics. We can only observe regularities and the rhythms of emerging and dissolving patterns. We can humbly model risk. We can never predict the future.

According to the Centers for Disease Control (CDC), for example, smoking increases the risk of lung cancer by 23 times in men and by 13 times in women. The CDC also tells us that excessive alcohol use is responsible for an average of about 30 years of potential life lost (YPLL). Yet, you can find a handful of chain-smoking, binge-drinking risk-takers who manage to live in good health for more than a century. The bottom line here is that colorful exceptions do not alter the dominant regularity: smoking kills.

Similarly, poorly governed companies whose accounting practices distort the economic value of the enterprise expose investors to material and avoidable risks.

When paradigms shift, shift with them.

Obsolete ideas don't always die peacefully. Long after they've outlived their usefulness, they still cling to life and resist the rise of superior ideas. Modern finance can be prey to obsolete ideas sustained by the force of cultural and institutional inertia. This will change because it is now in the best economic interest of every market participant to broaden the idea of risk and value.

In the history of progressive ideas that succeed in the struggle for survival, we find a common pattern. The ideas start out on the subversive fringe. Then, they attract followers and believers. Then, they build political power and soon achieve mainstream respectability. In the final stage, the idea gets woven into the cultural fabric. It starts to sound obvious, and it helps change institutional and individual behaviors and habits of mind.

Arguably, ESG/AGR has not yet entered this final stage characterized by broad mainstream consensus. In our view, this consensus is inevitable because the evidence is overwhelming, and so is the need for change.

A version of this essay first appeared on Business Insider, co-authored with James A Kaplan.