ESG Factor Integration:

Walden's Framework for Assessing Materiality

Environmental, social and governance (ESG) factors have a material impact on long-term corporate financial performance. As part of our investment analysis, Walden considers a spectrum of financial outcomes that are associated with ESG factors. This spectrum incorporates five broad areas that range from generally detrimental outcomes to those that are substantively beneficial: license to operate, risk reduction, operational efficiencies, competitive positioning, and new market opportunities.

FRAMEWORK FOR ASSESSING MATERIALITY

License to Operate

Any corporation's success depends on a broad range of stakeholders. The corporate "license to operate" may be effectively revoked by a consumer boycott, labor strike, community action, regulatory intervention, legal injunction, or some other stakeholder intervention. The Volkswagen (VW) emissions cheating scandal that hit the news in 2015, and resulted in Volkswagen issuing a stop-sale order on a number of models of vehicles in the U.S., is a prime example. Reportedly, the vehicles in question emitted up to 40 times the legal limit of nitrogen oxides that are linked to asthma and other respiratory problems. Civil fines could reach $20 billion, criminal prosecutions are possible, and U.S. sales declined between 10% and 25% year over year, all while competitor automotive manufacturers posted record profits. One report estimates the scandal could ultimately cost VW $86 billion.

Risk Reduction

Corporate activities may generate a variety of ESG risks requiring mitigation. Companies that are actively evaluating and managing ESG performance are more likely to avoid major controversies and be better prepared for events that could have a direct negative business impact. These risks include legal, regulatory, liquidity, credit, reputational, and others that could be materially costly to the firm.

There are countless examples of significant losses resulting from inadequate management of ESG risks. BP has said its total pre-tax charge for the Deepwater Horizon oil spill is approximately $54 billion. Major U.S. banks have paid more than $200 billion in fines for their role in fueling the subprime mortgage crisis that led to the global economic and market collapse in 2008.

The costs of discrimination in the workplace can also be significant. An appeals court upheld in June 2011 a $187 million class action suit against Wal-Mart for wage and hour discrimination, and in 2013 Merrill Lynch & Co. settled a racial bias case for $160 million.

ESG risks can lead to increased financing costs. A 2010 study by the European Centre for Corporate Engagement found that the credit spreads (yields relative to U.S. Treasuries of comparable maturities) of borrowing firms is influenced by legal, reputational, and regulatory risks associated with environmental incidents. Furthermore, numerous studies have demonstrated a positive correlation between strong ESG performance and lower cost of debit and equity. As a case in point, the credit rating of

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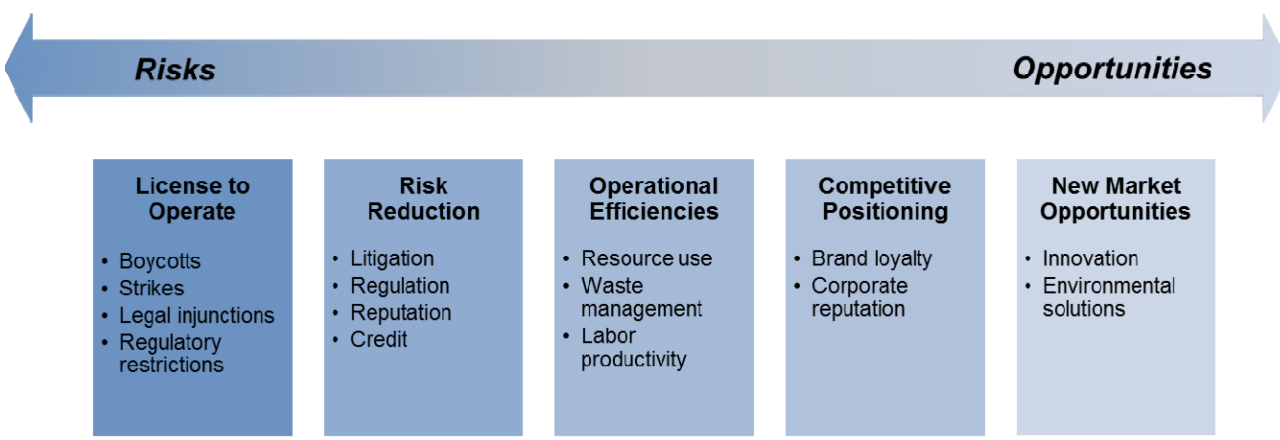

Tenneco, a manufacturer of automotive filtration products, was upgraded by Standard & Poor's because of the company's strong market share in clean-air products for which there is increasing demand due to environmental regulation.

No firm is immune to the prospect of future carbon regulations or the physical impacts of climate change. A company that monitors its carbon emissions and has set reduction goals will be better equipped to adapt to carbon regulation or other initiatives to put a price on carbon pollution.

Operational Efficiencies

Companies can reduce operating costs by efficient use of resources—financial, human, and natural capital. For example, efficiencies in the use of natural resources can result in significant cost savings. In 2012, Nike unveiled "Flyknit" technology, which enables the construction of shoes with up to 60% less waste than traditional production methods. Morgan Stanley estimates the technology reduces labor costs by up to 50% and significantly cuts material usage, resulting in improved margins.

Costco provides above-market wages and benefits to attract, motivate, and retain employees. CEO Craig Jelinek, a vocal proponent of the Fair Minimum Wage Act of 2013, stated, "Instead of minimizing wages, we know it's a lot more profitable long-term to minimize employee turnover and maximize employee productivity, commitment, and loyalty." Lower turnover also results in lower training costs. One report estimates that turnover costs one and a half times an employee's salary (The Saratoga Institute).

THE ACADEMIC RESEARCH

In 2015, researchers from the University of Hamburg and Deutsche Asset and Wealth Management published a review of 60 meta studies analyzing 2,250 unique empirical studies examining the link between corporate financial performance and ESG. The majority of studies found a positive correlation between ESG strategies and strong financial performance, while only 10% displayed a negative relationship.

More generally, a 2015 survey of nearly one hundred studies examined the relationship between human resource (HR) policies and corporate financial performance (IRRC Institute and Harvard Law School Labor and Worklife Program). The authors concluded, "The evidence for human capital materiality is sufficiently compelling to warrant investor requests for companies to report systematically on their training and other HR policies with clarity and depth, which would enable investors to assess their alignment with a company's business strategy."

Competitive Brand Positioning and Reputation

Sustainable corporate policies or practices can serve to enhance a firm's overall brand and improve competitiveness. According to a 2014 global survey conducted by Nielsen, a majority of online consumers would pay more for products and services from companies that are dedicated to positive social and environmental impact. Additionally, major customers of some companies are increasingly seeking better sustainability practices and transparency from their suppliers. Large companies, such as 3M, Apple, Ford, Intel, Microsoft, and Wal-Mart, require suppliers to undergo training, commit to audits, and increase disclosure on ESG performance. Many corporations select suppliers based on their efforts to minimize negative ESG impacts and demonstrate sustainable business practices.

INVESTOR EXPECTATIONS

Investors are asking companies for ESG information to better assess business risks and opportunities. As of April 2016, the U.N. PRI had more than 1,500 signatories with over $64 trillion of assets under management. These members seek ESG information from companies to better analyze the risks and opportunities associated with existing and potential investments.

Reputation matters to more than just customers. As concluded by the Great Place to Work Institute, organizations with reputations as good employers tend to attract high quality staff, directly correlating to productivity. A 2013 Bain & Company study found that "companies with highly engaged workers grow revenues two and a half times as much as those with low engagement levels. And…employees increasingly view their company's sustainability agenda as a critical factor in engagement."

New Market Opportunities

A company's success depends ultimately on growth. Products and services that maximize the efficient use of resources may provide their customers substantial cost savings and boost their own top lines. For example, Power Integrations offers technology that manages the flow of power into a device's power supply, resulting in significant energy savings for customers. In recognizing the ability of a particular product or service to provide a more sustainable outcome relative to peers, companies can boost financial prospects directly through new market opportunities. Indra Nooyi, CEO of PepsiCo, has noted that the company sees opportunity in providing healthy foods. Specifically, she has set a goal of growing sales from $10 to $30 billion by 2020 of food products that are "good for you."

FOCUS ON THE LONG TERM

Given the associated spectrum of financial outcomes, an appreciation of material ESG factors over a long term horizon is integral to a sustainable business model. Executives and investors who measure, manage, and disclose their policies and performance on ESG factors may have greater insight on this key dimension of overall company performance.

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