

ENHANCED ANALYTICS INITIATIVE

A photograph of a stage with a large red curtain. A hand is visible on the left, pulling the curtain back to reveal a dark opening. The bottom of the curtain has a gold fringe. The stage floor is highly reflective, showing the curtain and the hand. The text 'Research centre stage' is overlaid in white on the right side of the image.

# Research centre stage

Four years of the  
Enhanced Analytics Initiative



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Four years of the Enhanced Analytics Initiative

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**onValues**  
*investment strategies & research*

On behalf of the Enhanced Analytics Initiative



# Foreword

I am pleased and honoured to introduce this report, reviewing the past four years of the Enhanced Analytics Initiative. My involvement with EAI stretches back for most of those years as an associate member, but for the past year I have chaired the Initiative through changing times.

It is unlikely that any of us have experienced such a change as has taken place in global financial markets over the past year and continues to affect us. Call it a credit crisis or a liquidity crisis or a crisis of confidence or another example of 'boom and bust' or what you will. There can be no doubt that there has been a major impact on institutional investing across the globe, and those effects will continue for many years to come.

With a heavy dose of hindsight, it is easy to say that we should have seen these problems coming, but few did. Broader coverage of extra financial issues should have alerted us to poor governance, dislocated incentive structures, and bad capital management, but there is little evidence of such foresight.

That is not to say that better research would have averted these crises — other remedies are required to resolve those problems — but investors would have been better prepared to deal with the implications over a longer-term horizon.

I am not really here to comment on financial markets. However, recent events not only underline the need for the better research EAI was created to incentivise in 2004, but also the need for a step change in how investors request and use that research.

As this report highlights, EAI has been a ground-breaking initiative and a real global industry catalyst. We can evidence significant improvement in the quality and depth of research, and in how research is integrated into the investment decision-making process.

This marks the end of EAI in its present form and the beginning of a new direction. Joining forces with the Principles for Responsible Investment (PRI) is the next logical step in the Initiative's evolution, allowing us to internationalise and extend the call for EAI research with the benefit of PRI's global reach and broad signatory base.

I would like to thank onValues and Capital MS&L for their input over the years. I am grateful too for the support of EAI members who have contributed to this review and to the Initiative over the years.

This report reflects and records the success of their actions and diligence, and the significant response from the research community to our call.

I commend the report to you.



**Peter Scales**

Chairman

Enhanced Analytics Initiative

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## Commonly-used terms

EAI	Enhanced Analytics Initiative
EFI	Extra-financial issue
PRI	Principles for Responsible Investment

## Executive summary

The Enhanced Analytics Initiative (EAI) was established in mid-2004, with the objective of incentivising investment research that takes a long-term view and that integrates material extra-financial issues ('EFIs'). The Initiative intended to act as a catalyst for the mainstreaming of 'enhanced' research through a three to five year programme of operations.

The incentive mechanism employed by the EAI was a six-monthly evaluation of the quality of EFI research, with the Initiative's members committing to allocate a minimum of 5% of their annual brokerage or research budgets to the leading research providers. The Initiative also committed to communicate frankly and constructively with research providers over the course of the research evaluations.

From its establishment in 2004, the Initiative has grown strongly to its current level of 30 asset owners and managers representing more than EUR 2 trillion in assets (USD 2.8 trillion). As of June 2008 more than 11% of EAI full members' aggregate brokerage or research budgets were explicitly allocated on the basis of the EAI evaluations, more than double the commitment those institutions made in joining the Initiative.

The response of research providers to the EAI's challenge has been equally impressive, with full-service investment banking operations, brokerages with a strong research capacity and non-broker, independent research providers all producing high-quality research. Although global research operations have featured in EAI evaluations, many smaller and independent providers have also fared well in the biannual evaluations.

The interest of European asset owners and managers in analysing a broader range of risks and opportunities for their investments has helped to stimulate impressive output from research analysts in the region, with London and Paris emerging as centres of excellence in integrated EFI investment research. In contrast, the production of EFI research by US-based analysts has been more sporadic.

After an initial expansion in the number of research providers looking at EFIs, the EAI witnessed a consolidation to a group of 20–25 providers who were producing research that integrates EFIs. Within this group there was a separation between seven to eight providers with consistently high levels of quality and coverage, and the remainder, whose output was occasionally of high quality, but patchy in nature. The EAI believes that the defining characteristic of those leaders is an institutional commitment to make this kind of research part of their value proposition to clients. Such institutions have at an early stage invested in dedicated personnel, education for non-specialist analysts, internal and external research tools, and are beginning to leverage initial EFI efforts in new sectors, regions and asset classes.

In contrast, a number of research providers showed early promise but did not figure prominently in later evaluations. The output from these providers was generally generated by individuals or teams with a personal affinity for EFIs. However, without an institution-wide drive to scale up efforts they were unable to maintain the pace of improvement set by the leaders. However, high-quality extra-financial research was produced not only by specialist teams but also by mainstream analysts. Some of the best company research (e.g. on energy and utilities) was produced by sector teams with no visible input from EFI specialists.

The outcome of institutional commitment by leading providers was exponential growth in the quantity and quality of extra-financial research. The first three six-month evaluation periods saw an average of 20 individual pieces of EFI research per period. By the June 2006 evaluation, 173 pieces of EFI-inclusive research were submitted by members in 6 months.

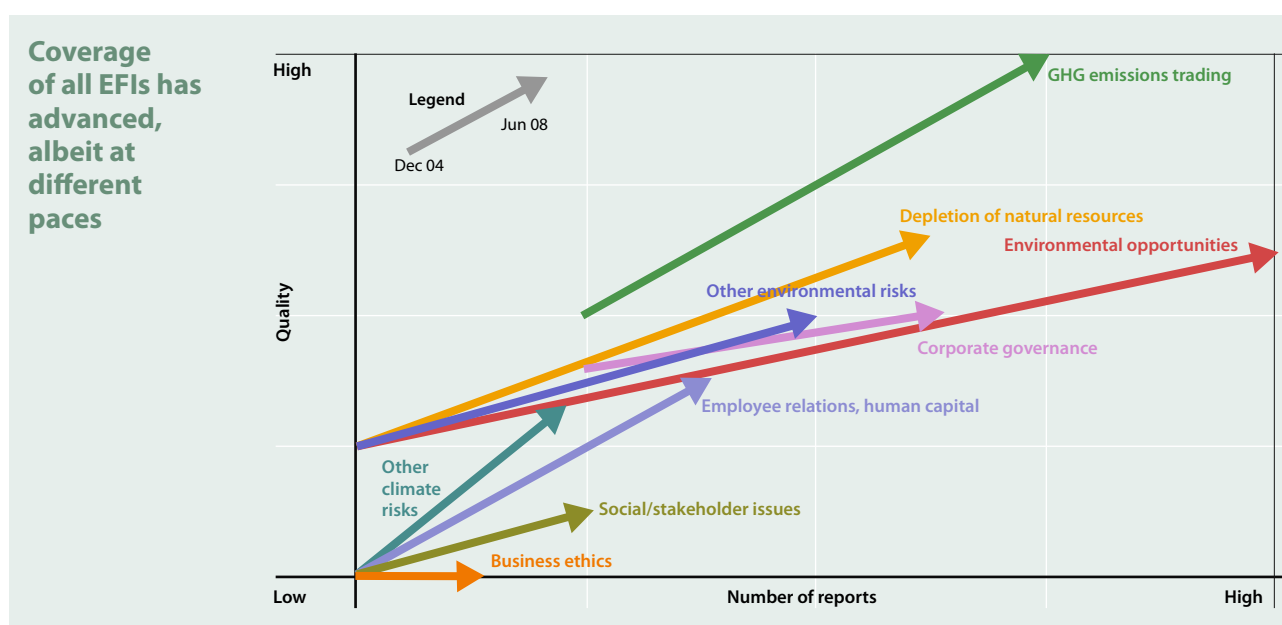
The latter evaluations saw EAI members inundated with research with some level of EFI content, requiring the Initiative repeatedly to make its definition of eligible research stricter. As such the 150 or so reports seen in recent six-monthly EAI evaluations represent only a small fraction — the cream of the crop — of the total EFI research output.

The approach most commonly adopted by research providers was EFI theme research. In other words analysts took an issue such as climate change or corporate governance and examined its economic impact across several sectors. This contrasts with the less common sector-based approach, where analysts would attempt to track down all the EFIs that were material for a sector such as materials or utilities.

Over the course of the EAI's existence, the broad spectrum of material extra-financial issues was not treated equally by analysts:

- Environmental issues saw the greatest growth in the quantity and quality of research, particularly where the driver was easily quantifiable (e.g. emissions trading costs)
- Research on governance issues progressed somewhat both in quantity and in quality. However, EAI members believe that governance is still greatly under-covered relative to its importance
- Coverage of material social issues was extremely rare, despite repeated appeals from the EAI to cover issues such as companies' stewardship of human capital

In the chart below we show a qualitative representation of how the quantity and quality of research on various EFIs has progressed during the lifetime of the Initiative.



Similarly, sector coverage has not been uniform. 'Heavy' industries with obvious exposure to environmental risks and opportunities, such as capital goods, energy, materials and utilities, featured most prominently. In contrast, significant industries such as banks and insurance, pharmaceuticals, and IT / telecommunications were under-covered, despite strong drivers related to governance, management of human capital, etc.

It remains to be seen whether the credit crisis of 2007–2008 will precipitate a surge of research into the long-term viability of bank business models and the corporate governance and incentives used at those institutions<sup>1</sup>.

Given that the EAI's founder members were based in Europe, it is understandable that the EFI research produced in the early stages of the Initiative mainly covered European assets. The research evaluated by the EAI has, however, gradually expanded to global research and increased coverage of North America, the Pacific region and emerging markets. Part of this story is the promising signs from Australia and Canada, where EAI members are engaging directly with local research providers. Nonetheless, the US and Japan — the world's two largest economies — remain strongly under-covered by EFI research.

<sup>1</sup> As we discuss later in the report, there may be systemic barriers to the research industry's coverage of EFIs for financials



## The next phase

The analysis of material extra-financial issues improves investment returns over the long term. This conviction prompted a ground-breaking four-year collaboration of investors representing USD 2.8 trillion in assets, which has catalysed the production of better investment research by providing tangible incentives.

Most major sell-side research institutions today provide some form of extra-financial research, and the research output has grown exponentially in the short lifetime of the Initiative. The engagement of EAI members and leading providers has helped to redefine best practice in investment research.

EFI-inclusive research has grown strongly in every sense (quality, the coverage of sectors, regions, asset classes, etc.), but a lot of work remains to be done, as highlighted by the EAI in the course of its assessments and communications. Despite important breakthroughs in terms of methodologies used and concrete examples of full and transparent integration, integrating EFIs into forecast financials and fair value calculations remains a particular challenge.

The next phase of research growth requires the involvement of a much more international group of investors. This is why the EAI is joining forces with the Principles for Responsible Investment (PRI), as announced in October 2008.

This union of the EAI's experience with the USD 18 trillion represented by PRI signatories comes during a period of extreme economic upheaval — a time when the need for better analysis of the risks and opportunities that drive investments could not be clearer. The incentives for providers to move investment research into a new phase of sophistication therefore seem stronger than ever.

# An introduction to the Enhanced Analytics Initiative

The Enhanced Analytics Initiative (EAI) was established in mid-2004 by four European institutional investors with combined assets of approximately EUR 330 billion<sup>2</sup>. These investors were united by the belief that:

- The investment research paid for through their brokerage commissions and research budgets did not capture adequately the full range of investment risks and opportunities to which they and their clients are exposed. Nor was the research consistent with their long-term investment outlooks<sup>3</sup>. The founders referred to the areas missing from the orthodox research provision as 'extra-financial issues' (EFIs)<sup>4</sup>
- In order to make their voices heard alongside those of shorter-term, trading-driven users of research, they should pool resources and speak with one voice through a new initiative
- EAI members needed to back their stated interest in research that integrates material EFIs with clear incentives for research providers. Research providers responding to the EAI's call should expect financial rewards through increased commissions from EAI members, and reputational rewards through public commendation by the Initiative
- The mechanism for the financial rewards for the leading providers of EFI research would be a commitment from EAI members to direct a minimum of 5% of their brokerage commissions or research budgets to the providers that performed best in evaluations of the published research. These evaluations would be independent and would follow a robust methodology agreed by EAI members

With these guiding beliefs, and with three further asset owners and asset managers joining the founding group of members, the EAI was launched late in 2004. The founding members intended the EAI to be catalytic and of finite duration (the members anticipated that the Initiative would run for three to five years), to evolve with the changing understanding of how extra-financial research is produced and used, and to feed back constructive criticism to research providers. The founders also announced their intention to recruit other like-minded asset owners and managers globally.

David Blood, Managing Partner, Generation Investment Management and former Chairman of the EAI, summed up the new initiative as follows:

"The EAI's goal is to incentivise research that enables long-term investors to make better investment decisions. Our purpose is to strengthen communications with research providers on the kind of research that best supports our investment decision-making and ownership practices — fundamental research that takes the long view and integrates material extra-financial issues."

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2 The institutions that announced the creation of the EAI in 2004 were BNP Paribas Asset Management, PGGM, RCM (including dbi / dit | Allianz Dresdner Global Investors) and the Universities Superannuation Scheme (USS). By the time of the launch of the evaluation process in November 2004 these institutions had been joined by Allianz Global Investors France (then AGF Asset Management), Generation Investment Management and the Mistra Foundation

3 Although the institutions that make up the EAI membership are heterogeneous in nature, common features include a long-term outlook and globally-diversified, mostly long-only investments

4 EFIs are best described as fundamentals that have the potential to impact companies' financial performance in a material way, yet are generally not part of traditional investment analysis

The EAI set out the method that it would use to send signals to research providers thus:

- A baseline evaluation of the quality of EFI-inclusive investment research
- Biannual independent evaluations of research output based on a robust methodology that would quantify the characteristics of individual pieces of research and the overall progress of research providers
- A limited group of 'recommended' research providers to be selected by the biannual evaluations
- EAI full members to award a minimum of 5% of their brokerage or research budgets to the group of recommended institutions
- Ad hoc case studies on particularly interesting areas of EFI-inclusive research

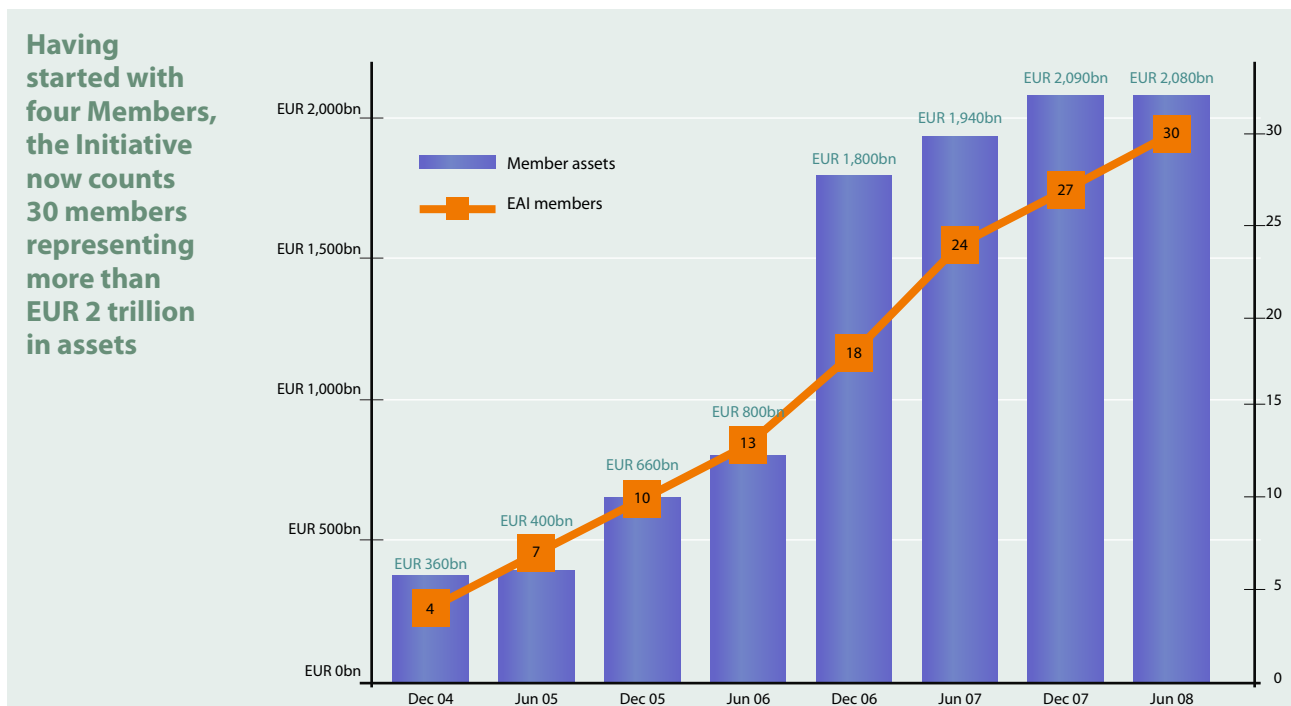
Having established the objectives and mechanism for the Initiative, in late 2004 the EAI commissioned independent investment consultant onValues to carry out the baseline evaluation of research. In parallel the Initiative set out to recruit other like-minded institutions.

## 2

## The commitment made by EAI members

### Growth of the EAI membership

From its establishment in 2004, the Initiative has grown strongly to its current level of 30 asset owners and managers representing more than EUR 2 trillion in assets (USD 2.8 trillion). On average the Initiative has added four institutions as members in each of the six-month evaluation periods since its foundation, with the EAI's assets growing at a compound annual growth rate of 65%.



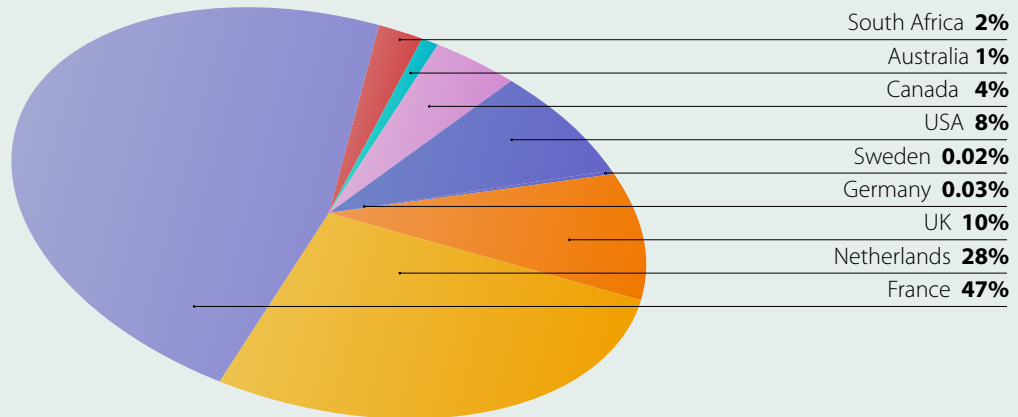
The Initiative distinguishes between full members (asset owners and managers that have a direct commercial relationship with research providers) and associate members (asset owners whose interest in investment research principally results from its use by their external asset managers). The EAI has attracted full and associate members in approximately equal numbers. Indeed, in a number of instances an asset owner and one of its principal external managers have joined the Initiative at the same time, thereby sending a consistent message to research providers<sup>5</sup>.

Although the 30 EAI institutions are approximately equally split between full and associate members, in terms of assets approximately 90% of the Initiative's weight comes from full members with direct commercial relationships with research providers. This proportion has remained approximately constant throughout the life of the EAI.

As to the provenance of EAI members, the Initiative began with a European core, and it is true to say that European-domiciled asset owners and managers are responsible for the majority of the assets (as can be seen from the chart below). Institutions from France, the Netherlands and the UK are particularly well represented. The US contingent is made up of the California State Teachers' Retirement System (CalSTRS), Calvert Group and the New York City Employees' Retirement System (NYCERS).

<sup>5</sup> Examples include BT Pension Scheme and Hermes Pensions Management (one of BT Pension Scheme's principal managers) and the recruitment of Bedrijfstakpensioenfond Metalektro (PME), Pensioenfond Metaal en Techniek (PMT) and Mn Services, their asset manager

The majority of EAI members are domiciled in Europe. However, the large asset managers that make up the bulk of the assets are global organisations



Despite the apparent dominance of European institutions, it should be noted that the largest EAI members — APG Investments, AXA Investment Managers, BNP Paribas Asset Management, RCM and Robeco (which have more than EUR 100bn under management) — truly are global investors with operations and research relationships throughout the world.

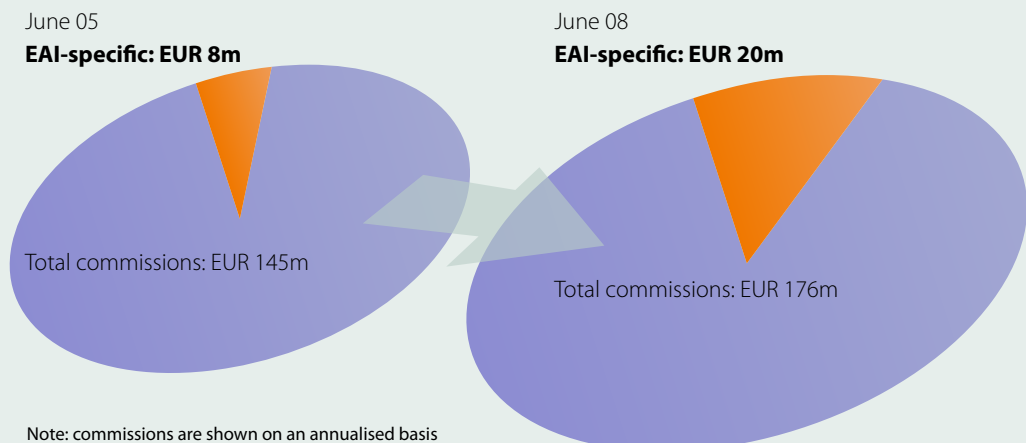
## The price signal

The number, profile and scale of the asset owners and asset managers behind the EAI has certainly been a component of its ability to send strong signals to the research market. However, the Initiative was designed such that there was not only an indirect incentive for research providers (to be ranked highly in the public domain by a group of large asset owners and managers), but also a direct commercial benefit that would accrue to outperforming research providers. The form of this direct benefit was the commitment by EAI full members that a minimum of 5% of their brokerage or research budgets would be awarded on the basis of the EAI evaluation results<sup>6</sup>.

Between June 2005 and June 2008 the annualised EAI-specific commissions grew from approximately EUR 8m to more than EUR 20m, an annual growth rate of 35% (see the chart below). This growth is all the more impressive given that between 2005 and 2008 a number of EAI members moved to unbundled brokerage and research budgeting, which would tend to reduce the size of the total and EAI-specific commissions pools.

As of June 2008 more than 11% of EAI full members' aggregate brokerage or research budgets were explicitly allocated on the basis of the EAI evaluation results, more than double the commitment those institutions made in joining the Initiative.

The total and EAI-specific commissions paid by member institutions has increased substantially during the Initiative's life



<sup>6</sup> The EAI's compliance with its commitment to allocating brokerage and research budgets based on the evaluation results was verified by onValues, the consultant that carried out the research evaluations

## Interacting with the research community

A key component of the EAI's effectiveness has been the frank and constructive interactions that it has had with research providers. These interactions have taken place through the publications and discussion forums that have accompanied each biannual evaluation and through bilateral, closed-door communications between EAI members and their providers.

**The EAI has published a series of analyses of the evolution of EFI-inclusive research, feeding back to research providers and the market as a whole**



## 3

## The response of research providers

Different types of research providers have responded to the challenge set by the EAI:

- Sell-side research departments of full-service banking operations (e.g. those of Citigroup, Goldman Sachs and JPMorgan)
- Brokerages with a strong research capacity (e.g. Bernstein and CM-CIC Securities)
- Non-broker research providers, including EFI specialists (e.g. Independent Minds / IRIS and Innovest Strategic Value Advisors)

The full list of research providers that featured in EAI evaluations, together with those providers recommended on the basis of the evaluation results, can be found in the appendices on pages 35 and 36 respectively.

In the early days of the Initiative a number of regional and smaller research providers raised the concern that, given that success in the evaluations was dependent on combining research quality with broad sectoral and regional coverage, they would not be able to compete with the global investment banks. Although many of the global investment banks, such as Citigroup, Deutsche Bank, Goldman Sachs, JPMorgan and UBS, have indeed been strong performers in the EAI evaluations, this has not been to the exclusion of smaller sell-side and independent research providers.

Indeed, many smaller providers have played to their regional strengths, with, for example CA Cheuvreux and Oddo Securities producing highly-rated research with a European focus, and CLSA producing extra-financial research on emerging Asia. Independent providers Innovest and the various partners of ESN (European Securities Network) have also appeared regularly in the evaluations.

Moreover, the EAI has always tried to showcase high-quality, innovative pieces of research from any provider, even if the coverage of those pieces or the low total research output of the institution meant that the provider was unlikely to feature in the final list of recommended providers.

The interest of European asset owners and managers in EFIs has helped to stimulate impressive output from research analysts in the region, with London and Paris emerging as centres of excellence in integrated EFI investment research. In the report on the June 2007 evaluation it was noted that French research providers seemed to have made a genuine investment in responding to the demand for enhanced research. This phenomenon includes both global players such as Société Générale and smaller institutions (such as the regional players noted above), both of which have decided to make EFI research a part of their value proposition<sup>7</sup>.

The production of EFI research by US-based analysts has been much more sporadic, and indeed coverage of US-based assets has been a mix of global reports produced in Europe and those produced by analysts in the US.

In latter EAI evaluations there was a steady increase in the EFI output of analysts based in Australia and Canada. This increase was due in no small part to the direct engagement with research providers by large asset owners in those countries such as HESTA Super Fund, UniSuper and VicSuper in Australia, and the CPP Investment Board in Canada. This research often focussed on large sectors in those economies with potentially high EFI exposure, such as materials in Australia and energy in Canada.

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<sup>7</sup> There are likely many factors behind the strong French showing. These include a heritage of looking at EFIs on behalf of traditional SRI / ethical investor clients, strong signals from French asset owners (notably public sector institutional investors) and the vocal presence of large asset managers such as AXA Investment Managers and BNP Paribas Asset Management in the EAI and similar initiatives



## Many of the largest global research providers have featured in the EAI evaluations



From the outset the EAI stressed that it believed that institutional commitment was required for a provider to fare well in EAI evaluations and, ultimately, provide its clients with a broad, sustainable service of extra-financial research.

The orange line on the chart on page 16 shows that the number of research providers producing EFI-inclusive research grew strongly through to 33 providers at the time of the June 2006 evaluation. Following this growth, the ever-increasing quality and quantity requirements for a provider to stay in the leading pack resulted in a consolidation to a group of 20–25 providers who were producing high-quality EFI-inclusive research. This development was viewed positively by the Initiative.

Even within this group, however, there was a separation between seven to eight providers with consistently high levels of quality and coverage, and the remaining 'pack', whose output was occasionally of high quality, but sporadic in nature. The leaders were mostly global research providers, but a small number of regional specialists were also featured.

A number of research providers showed early promise but did not figure prominently in later evaluations. The output from these providers was generally generated by individuals or teams with a personal affinity for EFIs. However, without an institution-wide drive to scale up efforts they were unable to maintain the pace of improvement set by the leaders. Alternatively, those individuals or teams left the institution, together with the know-how they had built up. Again the institutional policy and senior management support was not in place to sustain EFI research efforts in the absence of those fragile human assets.

The gap between the leaders and the chasing pack grew in the later evaluations. The Initiative firmly believes that the difference resulted from the fact that extra-financial research became a strategic axis for leading institutions, as opposed to an ad hoc activity by individuals or certain country offices. The leading research providers have support at the highest level to make this



kind of research part of their value proposition to clients, and have backed up that support with resources in terms of dedicated personnel (EFI 'centres of competence'), education for non-specialist analysts, investment in internal and external research tools, and plans to leverage EFI efforts in new sectors, regions and asset classes.

The rate at which global providers are scaling up EFI operations varies. EAI members commented, for example, that strong efforts by providers in their European and North American research were not mirrored by colleagues in Australia, Japan or the emerging markets. It is understood that time and investment are required for new specialist skills to be rolled out globally, but EAI members are hopeful that the leading providers will continue to encourage 'cross-pollination' between sectoral and regional teams.

High-quality extra-financial research was produced not only by specialist teams but also by mainstream analysts (with sector teams sometimes receiving input from cross-sectoral EFI centres of competence). Some of the best company and sector research (e.g. on energy and utilities) was produced by mainstream teams with no visible input from EFI specialists (teams that potentially had no knowledge that the EAI existed). Such reports simply tried to appraise all the long-term micro and macro factors that were potentially material for the company or sector, which led naturally to issues such as climate change, depletion of natural resources, companies' stewardship of human capital and corporate governance. The resulting research provided some excellent examples of how material EFIs can be woven seamlessly into the development of an investment thesis and, ultimately, into valuations and recommendations.

## 4

## Research output — progress in EFI-inclusive investment analysis

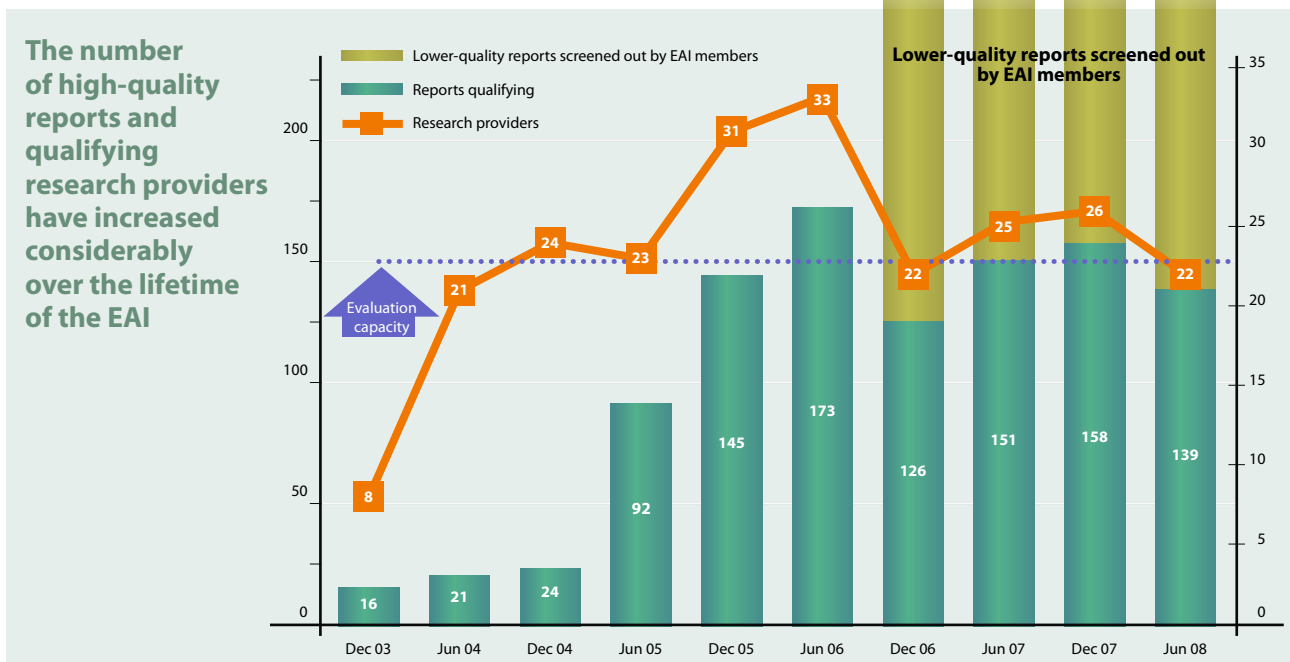
The commitment of leading research providers has led to exponential growth in the quantity and quality of extra-financial research.

The baseline evaluation in December 2004 attempted to capture all EFI-inclusive research produced in the 18 months to end November 2004. The evaluation was based on a total of 61 individual pieces of research, as shown by the first three columns in the chart below.

By the June 2006 evaluation (at which point the EAI had 13 members representing some EUR 800bn in assets), 173 pieces of EFI-inclusive research were submitted by members in just six months. The number of research providers producing such research also grew dramatically during these first two years of the Initiative.

The final two years of the EAI, covered by the four evaluations from December 2006 to June 2008, were characterised by a push from the members for higher-quality research. Members became more discerning about the research that they submitted for evaluation, notably screening out research that did not explicitly link long-term EFI drivers to company analysis<sup>8</sup> and reports that did not add usefully to the knowledge on issues such as utilities' emissions trading costs.

As a result, latter EAI evaluations sampled only the highest-quality extra-financial research. Members nonetheless reported seeing large volumes of research with some level of EFI content — far in excess of the 150 or so reports evaluated in each six-month period. This 'background' volume of basic extra-financial research is symbolised by the light green bars on the chart below.



A key observation arising from the EAI evaluations is that theme research dominates the EFI output. That is to say that the approach most commonly adopted by providers was to take an issue such as climate change or corporate governance and examine its economic impact across many non-contiguous sectors. This contrasts with the sector-based approach, where analysts

8 Many reports on clean tech companies fell into this category

would attempt to track down all the EFIs that may be material for a sector such as materials or utilities. The dominance of the former approach can be seen in the chart of the sector coverage of the June 2008 evaluation on page 21, where ‘cross-sectoral’ reports form fully 40% of the research body.

Theme research often included quantitative approaches that back-tested the historic share price performance of e.g. a ‘basket’ of corporate governance champions against a basket of underperformers. Although the Initiative welcomed quantitative research into the materiality of EFIs, such approaches also raised some concerns. For example, there may be limitations to looking for correlations in historical share price data for issues that, by definition, are not yet on the broad market’s radar screen. Additionally, return was often the only parameter presented by such reports, without any quantification of the risk that was spent to acquire that return. This omission is particularly troublesome when analysts are proposing higher-risk strategies to exploit an EFI theme (e.g. those involving small numbers of holdings, short positions or the use of leverage).

Whether EFI issues were examined through a theme or sectoral lens, EAI members were clear that the most highly-valued research was that which followed through strong theme analysis with investment recommendations at the level of individual assets. The notion that some of the best EFI research additionally seeks to integrate the issues directly into the financial analysis of individual companies is elaborated upon below.

Moreover, the Initiative noted that the research seen over the four years was, in the great majority, equity research that dealt with the micro-level impacts of EFIs. The EAI is hopeful that in the future EFI research will expand its coverage of non-equity asset classes such as commodities and credit, and that global issues such as climate change and resource depletion will feature more prominently in long-term macro or strategy research, and work on asset allocation.

## Integration

The appeals from EAI members to research providers for greater coverage of corporate governance, human capital and M&A, and to Japanese and North American analysts to rise to the EFI challenge (both of which are described in more detail below), have been among the Initiative’s ‘recurring themes’. However, perhaps the strongest thread that runs through the interactions of the EAI with the research community has been the appeal for EFI research to be integrated into the financial analysis of sectors, markets and individual companies.

The EAI has often stated that it sees the ‘end game’ for many types of EFI analysis as being the point where material EFIs are among the drivers of analysts’ forecasts of financial metrics, or are otherwise integrated into valuation methodologies<sup>9</sup>.

The EAI has seen many examples of full and transparent integration of EFI analysis into company financial analysis. The first comprehensive models to integrate EFIs in investment valuations were seen in the Jun-05 Evaluation. Many of these reports focussed on EFIs that are more easily quantified (e.g. the financial impact of carbon allowances in the utilities sector, or business opportunities in the clean tech field). They nevertheless clearly show that full integration is possible, and the value of being explicit about analytical methodologies and about the uncertainties inherent in making long-term financial forecasts.

However, full integration of EFI analysis when forecasting financials and calculating the fair value of companies has been a challenge for the majority of research providers. Many of the reports seen did not clearly establish a link between the theme- or sector-level analysis and financial analysis at the level of single companies. Often the reader is left with the sensation of ‘falling off a cliff’ when very rich analysis at the theme or sector level does not break through into the company-specific analysis, or is only described in general terms (with the reader left in the dark as to what extent extra-financials have actually been factored into the valuation of companies in the report).

Analysts more commonly assess an extra-financial theme and conclude their work with a list of stock picks based on companies’ revenue exposure to the theme. Although this is useful for buy-side analysts, it still leaves them with the task of evaluating the financial impact of the theme and putting it into context with other value drivers.

<sup>9</sup> i.e. where EFIs are a proportionate driver of profit and loss / cash flow modelling, or a component of cost of capital calculations, multiples-based valuations, etc.

## Extra-financial issues covered

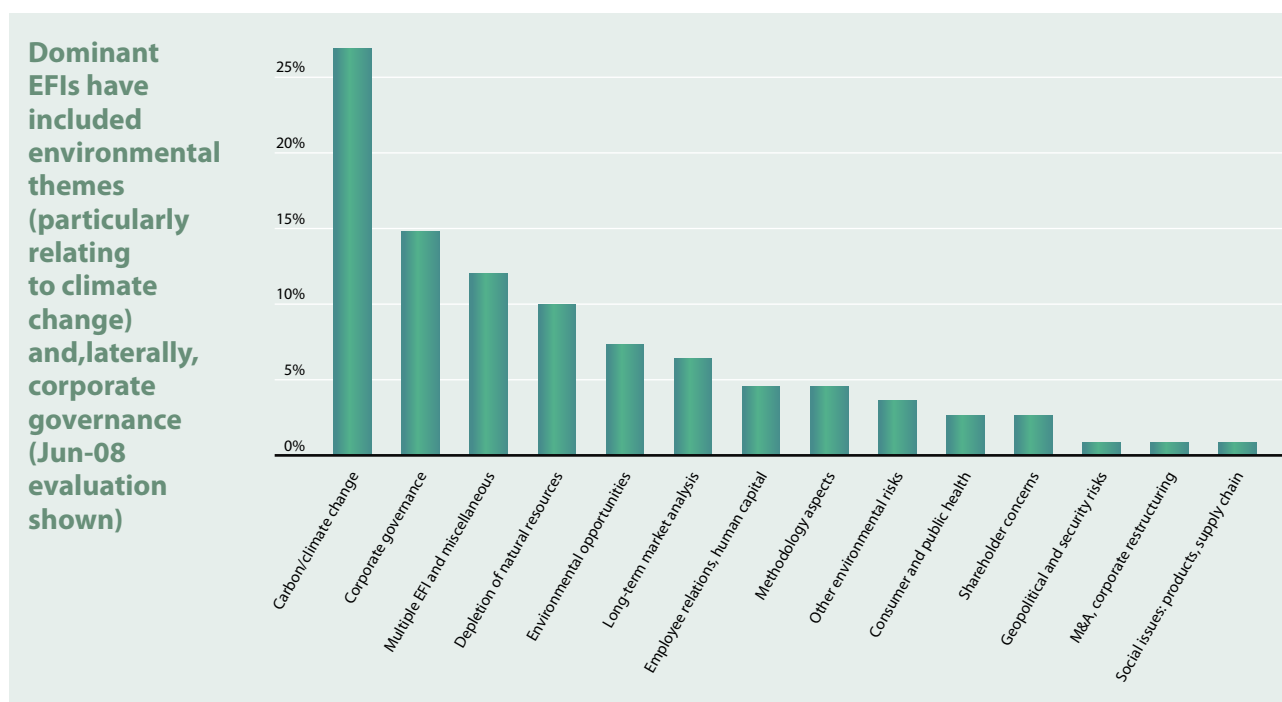
The enduring conclusion from the EAI evaluations is that research providers have not progressed their understanding of the three large axes of EFIs — environmental, social and governance issues — to the same degree. Broadly speaking:

- Environmental issues have seen the greatest growth in the quantity and quality of research, particularly where the driver was easily quantifiable (e.g. emissions trading costs under the European Union Emission Trading Scheme (ETS)) or where there was a strong opportunity story (such as clean tech)
- Research on governance issues has progressed somewhat both in quantity and in quality. However, EAI members believe that governance is still greatly under-covered, given its universal importance across sectors and regions, and the fact that corporate disclosure on governance is often good relative to other EFIs
- Coverage of material social issues is very sporadic. Following repeated appeals from EAI members some providers analysed how companies steward their human and intellectual assets. However, reports on the ability of stakeholder issues to have material financial outcomes have been few and far between

The chart below, which shows the abundance of the major EFIs in the most recent EAI evaluation, shows the dominance of environmental issues in the research body. There is, however, a story behind each of the columns.

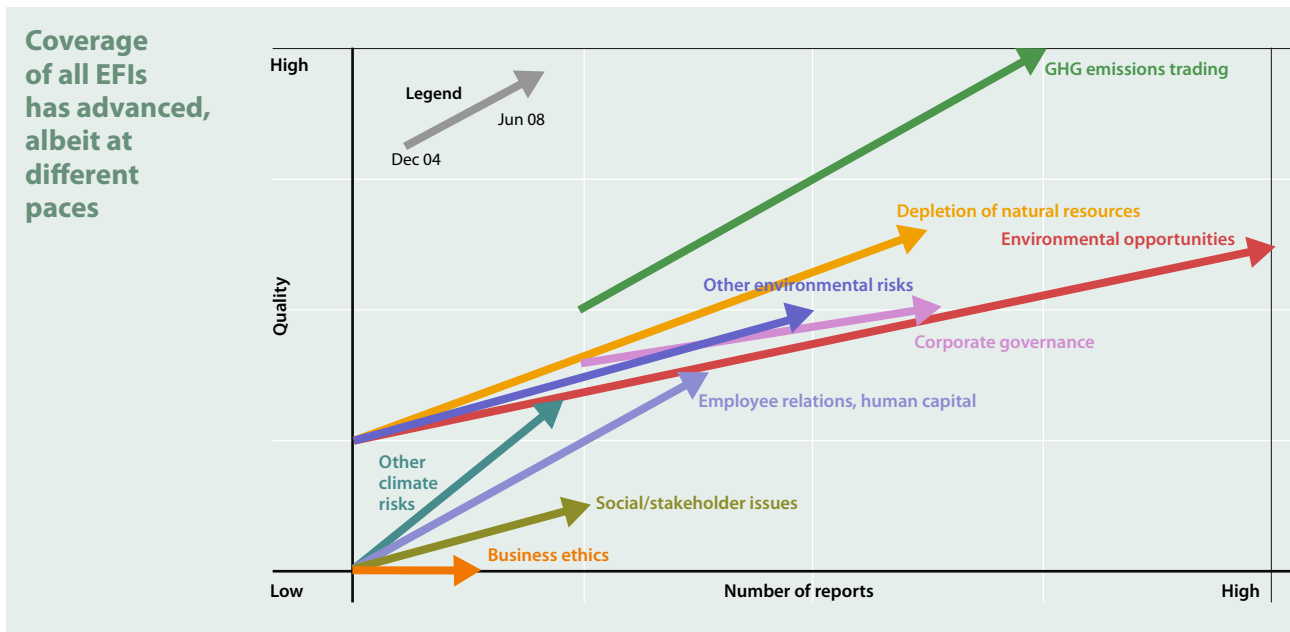
For example, the dominant climate change research is strong on the simple quantification of greenhouse gas emissions under the ETS, and on the likely upside and downside for high-emissions sectors such as energy utilities. In contrast, much less coverage has been seen of the physical risks that climate change may pose to businesses and whole sectors, such as the extractive industries, or risks to telecommunications or utilities infrastructure.

Similarly, although corporate governance has risen to become the second most frequently-covered EFI (see also the chart on page 18), EAI members believe that we are still a long way from the point where examining corporate governance quality is as routine a task for analysts as is looking at the audited financial statements. Moreover, related issues where the metrics are less clear, such as business ethics<sup>10</sup>, corporate culture, and the quality of management systems, are almost entirely absent from the research body.



10 Issues relating to fair competition, bribery and corruption, government relations, etc.

In the chart below we present qualitatively the progress for some of the major EFIs over time. The horizontal axis shows how the volume of reports on each issue has changed over the course of the EAI, and the vertical axis the change in the perceived quality of that research.



One pleasing outcome is that all the major issues have shown improvements in the quantity and quality of coverage, although the total progress and the end-point in terms of quantity and quality vary greatly.

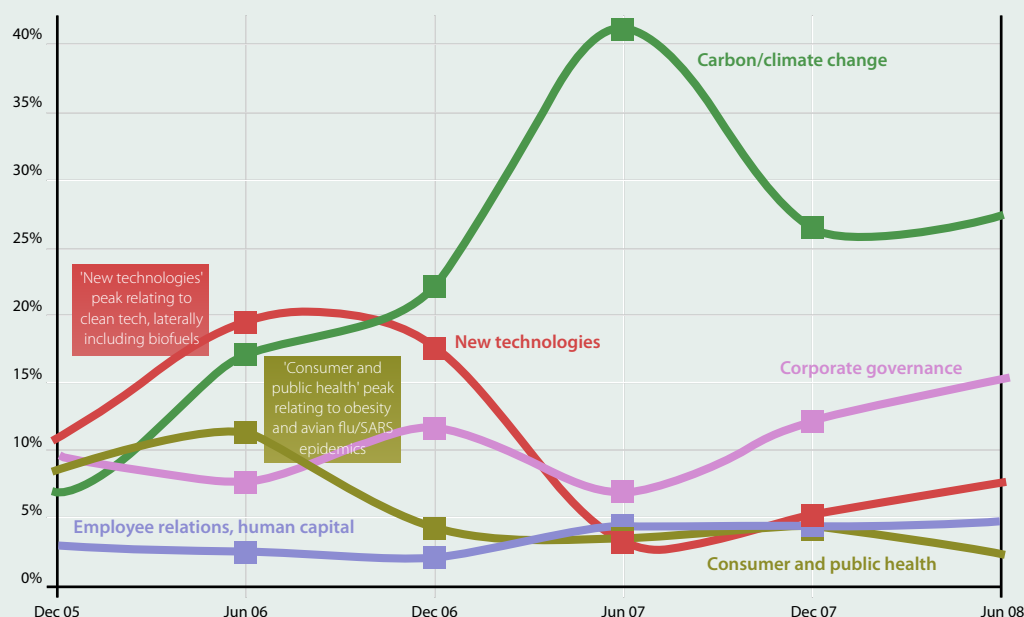
The treatment of climate change provides a good example of how the understanding of issues can evolve rapidly. With climate change we have seen a clear trend in analysts moving from simple treatment of the issue (without a clear financial / investment context), to easy quantification of emissions costs in exposed sectors (e.g. utilities), through to detailed integration of the risks and opportunities at the level of company financials. Indeed, some of the quantification work done in the utilities sector serves as a paragon of what is possible in terms of analysing extra-financial issues in a robust, financially-focussed way.

The final step on this path, seen in the most recent EAI evaluations, has seen analysts taking a systems view on climate change, looking at physical risks, macro effects and the interaction of climate change with other issues such as water scarcity and social issues.

Research on environmental opportunities has also come to the fore. Clean tech and water & waste research have greatly increased in volume, and can now clearly be considered part of the mainstream research offer. The Initiative decided that coverage of companies in growth industries related to the environment (energy supply, waste management, etc.) only constituted EFI research where the investment case was explicitly linked to some of the long-term drivers such as climate change, resource scarcity, etc. Therefore many environmental opportunities reports were not considered in the later evaluations.

The early peak of research related to new technologies can be seen on the chart on page 20. In this chart we trace the abundance of research on certain issues over the lifetime of the Initiative.

Some issues have seen peaks of interest over the course of the Initiative (selected EFIs shown from Dec-05 – Jun-08)



As explained, the tailing off in the new technologies peak resulted primarily from waning EAI member interest in specifically rewarding this research — the issue had clearly gone mainstream, and in many cases the later reports did not provide additional insights relative to the initial rush of research (e.g. many ‘me too’ reports were seen on biofuels). Short-term outlooks and unclear links between driving issues such as resource scarcity and the company analysis were also a shortcoming of many of the later new technologies reports.

In other cases, however, a large number of reports were published simultaneously in response to a single, scene-shifting event (such as new regulations for auto emissions and new accounting measures for corporate pension schemes). Likewise other EFIs of interest fell off the radar screen when their impact was judged no longer to be material. This is the case with the early peak in the yellow ‘consumer and public health’ line in the chart above, which reflects analyst interest in the avian flu and SARS epidemics, and in corporate responses to obesity, all of which received considerable attention in the media for a certain period of time.

The 2005 Atlantic hurricane season, the most active and costly in recorded history, stimulated interest in climate change in general, and specifically in physical impacts and the risks to the insurance industry. Although the climate change issue has come to dominate the research seen

by the EAI, the potential for increased storms and flooding to impair fixed assets, disrupt business operations, etc., has not stayed in the spotlight. The potential upside and downside for the insurance industry also remains under-covered.

### Case study EFIs in M&A research

In April 2007 the Initiative released a summary of a case study on the coverage of extra-financial issues in investment research on mergers and acquisitions (M&A). The study, which was performed by onValues for EAI members, found that the overall volume of ‘enhanced’ EAI research was low. Corporate governance was occasionally identified as potentially impacting the merits of pending transactions, but coverage of environmental and social issues was very rare.

Details can be found on the EAI website.

It remains to be seen whether the credit crisis of 2007–2008 will precipitate a surge of research into the long-term viability of bank business models and the corporate governance and incentives used at those institutions. As we discuss later, there may be systemic barriers to the research industry’s coverage of EFIs for financials.

The chart above also reveals that coverage of corporate governance has gradually grown throughout the EAI’s existence. Nonetheless, coverage of this crucial issue for long-term investors, whether in the form of dedicated research or as an accessory ‘risk check’ as part of a broader investment thesis, is still at an unsatisfactory level in the eyes of EAI members.

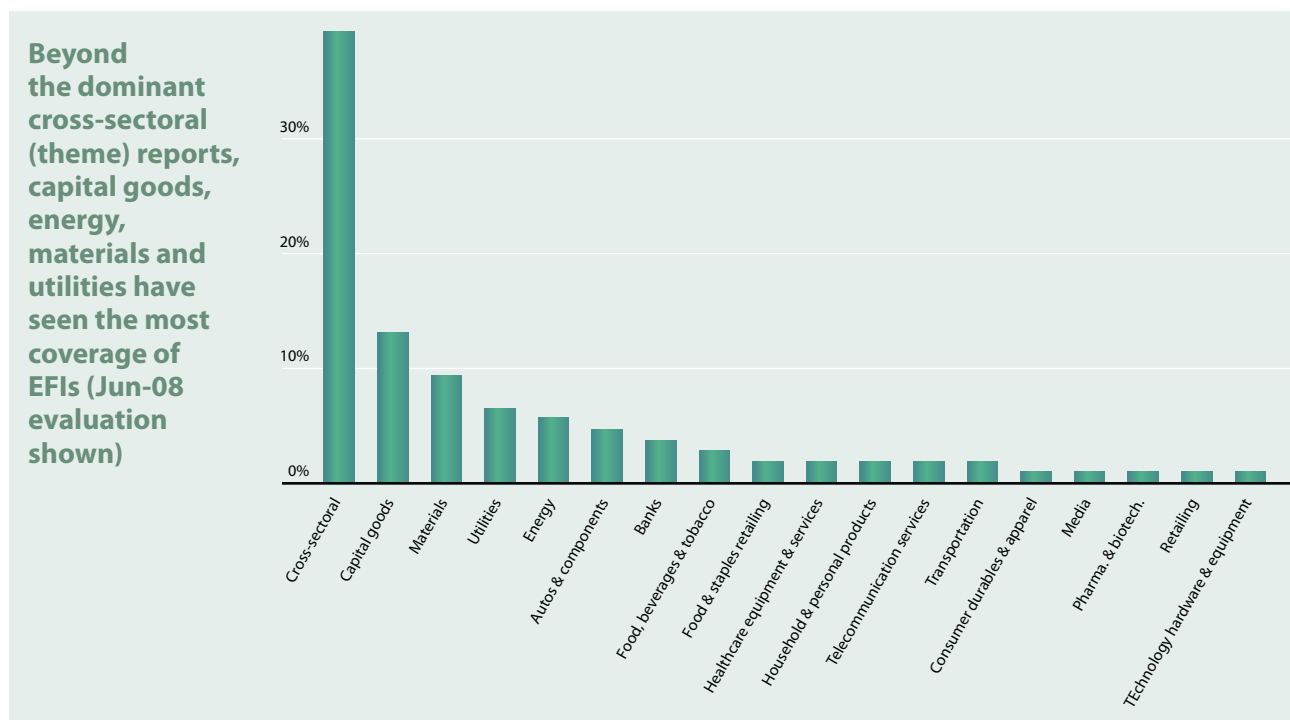
A small number of research providers seem to have decided that corporate governance will be a consistent focus of their research, producing both broad sectoral and thematic research, and in the case of one provider, event-driven governance alerts. There seems to be little competition from other providers active in the EFI space, and indeed some EAI members have indicated that although the responsibility for corporate governance is often given to the same specialist analysts that cover environmental and social issues, the two skill sets are not necessarily complementary.

It may also be that specialist voting research providers take over the role of mainstream providers in terms of broad-based research. Nevertheless, it seems that there is still a place for research into the more strategic aspects of corporate governance.

Another issue for which the EAI has made repeated appeals for greater coverage is employee relations and human capital. The chart on page 20 shows that from the December 2006 evaluation onwards there was a minor uptick in the coverage of these issues. However, absolute levels of coverage of what is believed to be a key long-term driver of many sectors remain low.

## Sectors

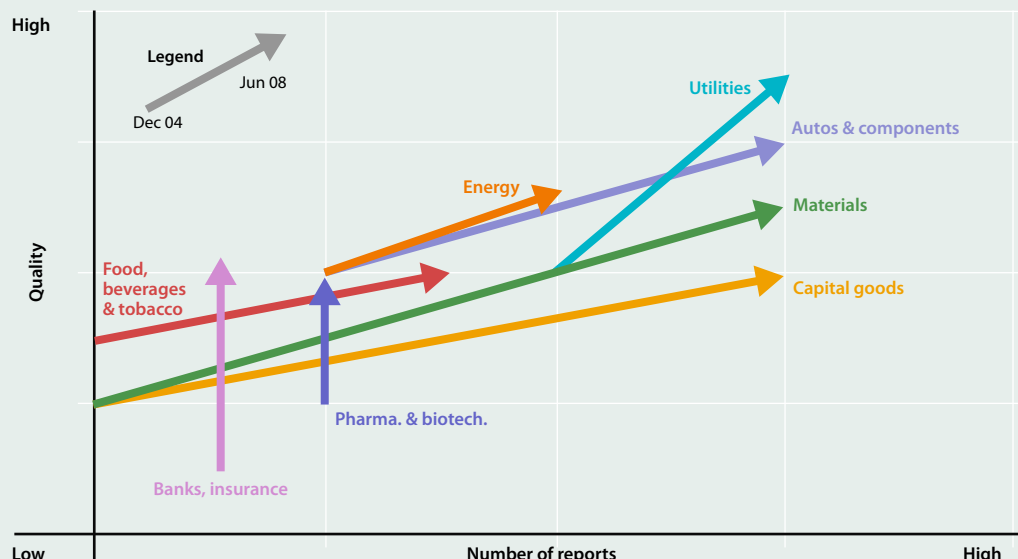
The most abundant research seen by the EAI — 40% in the most recent evaluation — looked at the potential impact of an EFI on several sectors, rather than using an industry framework and looking for the EFIs that may be material for that industry. In many instances the research is theme driven, where the analyst proposes satellite 'plays' on an EFI theme, or investigates secular themes that are expected to affect asset allocation.



In terms of research concentrating on individual industries, capital goods, energy, materials and utilities were all frequently covered. To a certain extent this coverage mirrors the predominance of environmental issues — the industries mentioned are often strongly geared to the upside or downside relating to climate change, resource scarcity, etc.

In the chart below we show qualitatively the changes in the number and quality of reports on large industry groups between the beginning and end of the EAI. The large strides made by capital goods, materials and utilities are obvious. We can also see the strong progress in the quantity and quality of the coverage of automobiles & components, a small industry that nonetheless received extensive coverage due to changing regulatory frameworks in Europe and North America.

The progress in the number and quality of reports on large industry groups has not been uniform (selected industry groups shown)



A less appealing story is told by the arrows in the chart for banks and insurance and the pharmaceuticals, biotechnology & life sciences industry group. In both cases the EAI observed minor improvements in the quality of the research, but essentially no increase in volume from a low base. (Other large industries such as IT and telecommunications also saw very little coverage.)

### Case study

#### Coverage of EFIs in pharma research

In August 2005 the Initiative commissioned an ex post case study of how pharmaceutical industry analysts had reacted to two threats to the long-term viability of the industry's business model.

The study used the COX-2 inhibitor drug crisis and the issue of generic drugs for emerging markets to evaluate how research providers treated 'game-changing' EFIs. The study was notable for the direct engagement of EAI members with leading research providers (as identified by prior EAI evaluations).

Details can be found on the EAI website.

This is noteworthy given the weight of financials and health care in our economies. In the case of financials we are currently experiencing the full force of the storm created by the misalignment of business models, governance controls and incentives with the interests of long-term shareholders.

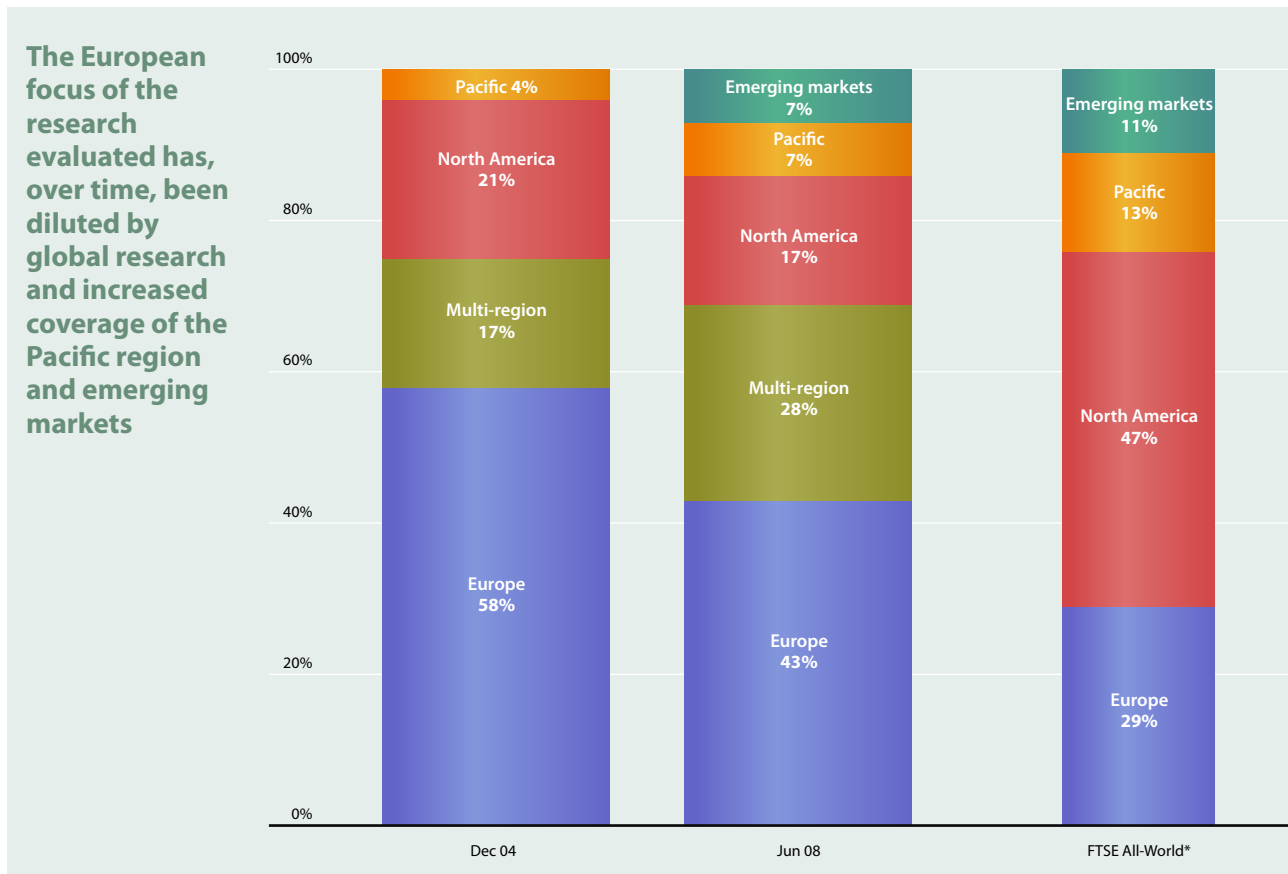
That they have not been able to stimulate more research on these industries is an area of substantial concern to EAI members. Indeed, some members have hypothesised (and research providers corroborated during EAI face-to-face meetings) that the lack of

coverage of EFIs in financials is as much a result of conflicts within the research industry as it is a lack of interest of the analysts in governance and related issues. This points to an important role that independent research providers could play in filling the gap.



## Regions

Given that the EAI's founder members were based in Europe, it is understandable that the EFI research produced in the early stages of the Initiative mainly covered European assets (EAI founder members had the strongest relationships with European analysts covering their home markets). The dominance of these reports also arguably reflected the greater sensitivity of European companies at the outset of the Initiative for the interaction between business, the environment and society.



\* The FTSE All-World Index, an indicator for the sizes of global investable equity markets, is shown for reference as of 31-Aug-08

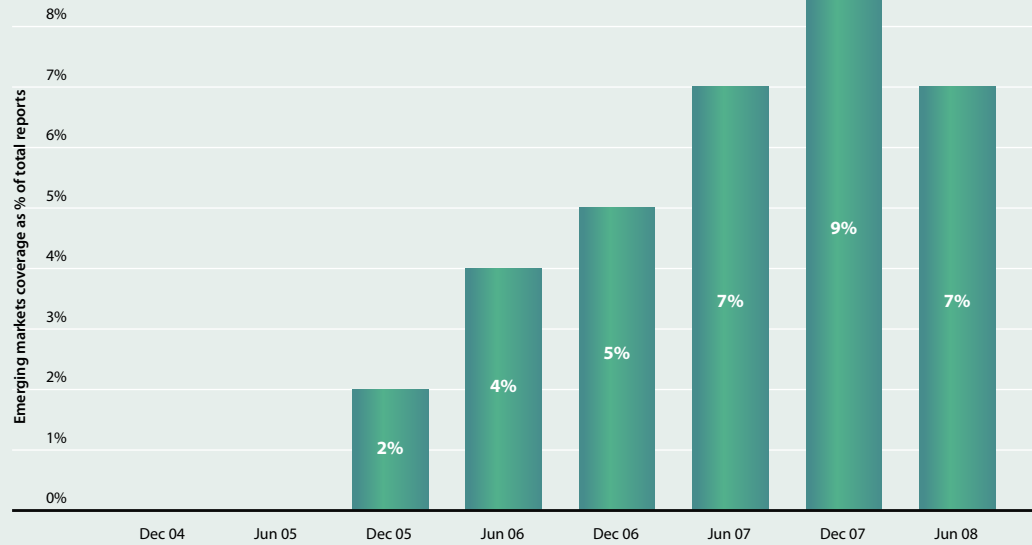
However, as the EAI's membership has grown, adding members in Australia, North America, and other regions, and as the global scale of environment and challenges increasingly captured political attention, so the research seen by the EAI has diversified regionally. Between the baseline evaluation in December 2004 and the final evaluation in June 2008 research on European assets fell from 58% of the research universe to 44%. In the same period multi-region reports (e.g. EFI theme reports looking at global plays on themes such as carbon capture and storage or urbanisation) and coverage of emerging markets grew strongly.

Additionally, the chart does not show the promising signs from Australia and Canada, where EAI members are engaging directly with local research providers to request research on the most material issues and most exposed sectors in their home economies.

Despite the globalisation of EFI research encouraged and witnessed by the EAI, large imbalances in the research provision remain. By comparing the coverage of the research in the EAI evaluations with the FTSE All-World Index (chart above), we see that the US and Japan — the world's two largest economies (which respectively make up the bulk of the North America and Pacific regions) — remain strongly under-covered by EFI research.

Likewise, despite the strong growth in the research on emerging markets seen by the EAI (see the chart below), this region remains underweight relative its capitalisation, and the coverage is strongly skewed to a few large markets such as China. When compared to the GDP and growth prospects of emerging markets, the lack of research coverage is even starker.

**Coverage of EFIs in emerging markets has increased from a very low base**



The EAI believes that this gap represents a great opportunity for leading research providers. It is generally accepted that EFIs can have stronger impacts in emerging markets, both at the micro and the macro levels. Providers who can produce financially-focussed EFI research not just on the BRICs but also on Korea, Mexico, South Africa, Taiwan, new Europe, other emerging markets and perhaps even frontier markets<sup>11</sup>, should be in a position to deliver a significant information advantage to their clients.

11 Countries whose markets are in the tier below emerging markets in terms of investability

## 5

## Conclusions and thoughts on the future evolution of the market

### High-quality research drives better investment decisions

The EAI is more convinced than ever that high-quality extra-financial research is a prerequisite for better investment decisions, and that both sell-side and independent research have an important role to play in its provision.

The EAI has been a ground-breaking collaboration of investors, acting as a catalyst for the integration of extra financial into investment research. It has achieved this by delivering tangible incentives during the start-up phase in the provision of such research (where there are three phases: start-up, expansion and maturity).

### Extra financial issues are a component of high-quality research

EAI members believe that the Initiative has fulfilled its goal of helping the industry to navigate through the start-up phase and well into the next phase (expansion). The evidence for this includes the facts that most major sell-side research institutions now provide some form of extra-financial research, and that the research output has grown exponentially in the short lifetime of the Initiative.

The adoption of the EAI 'paradigm' for EFIs at certain research providers, and their response to the EAI appeal for greater coverage of e.g. corporate governance and human capital, further indicates that the EAI has been one of the drivers of the gradual change in the scope of investment research.

### Quality research requires adequate resourcing

The EAI acknowledges that EFI research is a relatively sophisticated (and hence expensive) product, and that not all research providers will wish to take on the challenge. Those that do must be ready to invest in it and to make it an important part of their business strategy and research philosophy.

The EAI also acknowledges that asset owners and managers must be prepared, as part of the normal business relationships with research providers, to bear a part of the costs involved in developing the new services.

### Investors must articulate their needs

The buy side should also engage more actively with providers in order to clarify its needs and to improve the provision of EFI research tailored to these needs.

### Good research demands broader market usage

Other investment market players, including credit rating agencies and data providers, should better take into account extra financial issues in their services in order to facilitate the work of the analysts at research providers and on the buy side.

### Successes to date drive the need for evolution

Success in the next phase (expansion) will require the involvement of a much more international group of investors (hence the involvement of PRI). The provision of this type of research must also be embedded in the normal business relationships between the buy side and their research

providers, as opposed to being dealt with by collaborative initiatives such as EAI (the collaboration was nonetheless essential during the start-up phase). In future it will also be important to expand the extra-financial thinking to other services offered by research providers, including bespoke research, ad hoc information requests, facilitated management access, etc.

In spite of the strong expansion of EFI-inclusive research (in every sense — quality, the coverage of sectors, regions, and asset classes, etc.) a lot of work remains to be done, as highlighted by EAI in the course of its assessments and communications:

- The institutional commitment of some research providers is still weak and their research offer opportunistic and patchy
- Important regions and sectors are still under-researched, as highlighted by this report
- In spite of the highly innovative and ground-breaking work done by some analysts, the research is often repetitive and not particularly forward-looking or challenging<sup>12</sup>
- The research is often driven by specialist teams rather than by mainstream analysts, which indicates the work that still needs to be done to capture 'mindshare' among mainstream analysts

## Integration is a challenge, but the challenge can be met

Better integration of EFIs when forecasting financials and calculating the fair value of companies remains a challenge. The last year has nonetheless seen important breakthroughs in terms of methodologies used and concrete examples of full and transparent integration. Indeed, an important legacy of EAI is the fact that leading analysts have demonstrated that quantifying financial impacts of extra-financial issues, in spite of their often uncertain and long-term character, is absolutely within the reach of the analysts' profession.

## The timing and incentives are right for the next phase of enhanced research

The EAI has helped to redefine best practice in investment research, and is now joining forces with the USD 18 trillion represented by PRI signatories. This union comes during a period of extreme economic upheaval — a time when the need for better analysis of the risks and opportunities that drive investments could not be clearer.

The incentives for providers to move investment research into a new phase of sophistication therefore seem stronger than ever.

### The EAI's immediate future

In early October 2008 the Enhanced Analytics Initiative and the Principles for Responsible Investment (PRI) announced that they would join forces under the PRI name to internationalise the call for better investment research. With joint assets under management of more than USD 18 trillion, this new approach will represent a single, powerful voice within international investment markets. These institutions will continue to encourage the production of better-integrated and longer-term research covering in all regions of the world, and will make the research available to a far wider audience than the EAI membership.

The decision to join forces with the PRI Initiative will necessitate changes to the existing EAI process, which currently involves a bi-annual evaluation of investment research and an incentive to those research providers who produce high-quality EFI research through the allocation of commissions. A working group comprising of both EAI members and representatives from the PRI has been established, which will in December 2008 detail how the combined initiatives will support research providers.

The intention of EAI members to support the integration of EFIs into investment analysis and to reward the research providers that take the biggest steps in this regard is unwavering.

12 This is true of investment research in general, not just EFI research

## 6

## Illustrative reports

In this section we present a selection of reports that show the richness of topics treated by research in the EAI evaluations. Please note that this list does NOT present the highest-scoring reports on a total score basis, but rather a selection of research with notable qualities. Research providers are shown in alphabetical order.

## Company / sector reports

Research provider	Title	Report summary	Date	Region	Author
Bernstein	Wal-Mart: How Much Could the 'Company of the Future' Vision Be Worth To Shareholders?	This is one of the strongest EFI company reports seen by the EAI. In his speech on 23 January 2008 entitled 'The Company of the Future', Wal-Mart CEO Lee Scott outlined the retailer's plans to increase health care affordability and accessibility for customers, employers, and associates, reduce energy costs for consumers, and develop and enforce social and environmental standards for suppliers for Wal-Mart (as well as other major global retailers). The authors of the report assess in detail the potential impact of Scott's initiatives on Wal-Mart's top and bottom lines, including the estimated customer goodwill boost that the company might generate if it successfully executes its plans. The report therefore 'hits the mark' in terms of the integration into financial analysis for which the EAI has asked.	Jan-08	North America	Uta Werner, et al.
CA Cheuvreux	Sustainable Chemicals: Green, white and red chemistry	A highly strategic analysis of the investment opportunities arising from 'green', 'white' and 'red' biotechnology, which rely in part on EFI drivers including climate change and the environmental impact of the chemicals industry. Long-term market opportunities and growth rates in terms of various sub-industries and technologies are given, however calculations are not transparent. At the company level exposure to the various themes described and some quantification on the impact on future sales and margins is given.	Apr-07	Europe	Patrick Lambert, et al.
CIBC	Adapting To A Greener Landscape: Implications For Canadian Oil & Gas Companies	This sector report from CIBC looks at the likely impact of future greenhouse gas emissions legislation in Canada on the major domestic oil companies. Although the theme has been well covered by other providers, the Canadian context is somewhat novel. The analysis is notable for its very long-term nature (forecasts are made out to 2025 and beyond), the discussion of the political climate and regulation and the national and provincial levels, and for its strong statements of materiality, e.g., "In conclusion, we believe investors should be taking companies' environmental performance into consideration in the stock selection process.". At the company level P&L impacts are calculated for the main Canadian players, with an illustrative NPV impact being shown for one of the companies.	Apr-08	North America	Robert Plexman, et al.
Citigroup	Royal Dutch Shell Class A: Sakhalin II: many rivers to cross	A 'best-in-class' report focussing on environmental and stakeholder issues in project finance. Citigroup analysts draw conclusions from a meeting with Shell's Sakhalin II oil and gas field operators on which environmental factors contributed to the \$10bn cost overrun of the project, whether these costs will be recoverable from the Russian Government, if environmental factors could cause any further delays or costs, if these factors will impede the company's ability to raise debt finance, whether investors should draw from the Sakhalin experience any wider lessons about RD Shell's ability to deliver complex projects in future. The authors assess in detail potential impacts on the project's financials, but not on Shell's overall bottom line.	Dec-05	Europe	Jonathan Wright, et al.
Credit Suisse	Disease Management	The authors of this report argue that rising healthcare costs, obesity, increased interest in preventative care, the ageing of America, and more, promise to create greater demand for disease management and wellness service companies in the US and to fuel growth for years to come. The report is notable for its focus on long-term social and healthcare trends, and the political debate that will determine the future of Medicare. The report includes detailed analysis of the two leading companies, Healthways and Matria Healthcare, with valuations that take described trends fully into account.	May-07	North America	Michael Glynn, et al.

Research provider	Title	Report summary	Date	Region	Author
Credit Suisse	The Inconvenient Math: Implications of Costed Carbon	Convinced that serious legislative changes will occur in 2009/10 to mandate CO2 reductions, the authors of this report show the expected repercussions on US utility financials and valuations in a very comprehensive, quantitative and integrated way. The results are very illuminating and provide responses to questions such as 'What can the utility industry actually achieve in terms of emissions from today's levels given existing infrastructure?'; 'What does the price of carbon need to be in order to change existing economics to meet goals?'. This breakthrough report could potentially influence the public policy debate.	Nov-07	North America	Dan Eggers, et al.
Deutsche Bank	European Oil Services: Risking execution: seeing before believing	Excellent report on the concept of management quality. Deutsche Bank presents an interesting analysis of risk profiles of European oil service companies prepared in conjunction with global risk consultancy Nielsen-Wurster / Pegasus. Execution risk is broken down in the four categories geopolitical, technological, contractual and financial risk. The research is highly innovative, e.g. in its detailed analysis of corporate risk management quality and of the relative sensitivity of each company's fair value on its largest contracts. The EFI analysis is fully integrated into company valuation.	Oct-06	Europe	Christyan Malek, et al.
Deutsche Bank	Tatneft: Corporate governance: as yet only formal improvements	This company report on Tatneft states that the market has overvalued corporate governance improvements at the company, which the authors believe to be largely cosmetic. The authors analyse in particular Tatneft's IPCG fund ownership and recent asset disposals, which the authors consider to have been suboptimal for the minority shareholder. The fair value of the company is calculated by DCF, the discount rate for which explicitly includes a corporate governance risk premium (which is itself based on a number of factors).	Jul-07	Emerging & frontier markets	Pavel Kushnir, et al.
Goldman Sachs	Pharmaceuticals: GS SUSTAIN: Integrating ESG	Goldman Sachs continues its 'Integrating ESG' series with coverage of global pharma. As with previous reports in this series, the sector-adapted ESG framework is used as a proxy for overall management quality, and as an indicator for cash returns and therefore fair value. The report weaves the ESG story with other, 'orthodox' strategic drivers, and is very transparent in its ESG methodology.	May-07	Multi-region	Sarah Forrest, et al.
Goldman Sachs	Utilities: 2020 vision: Favour low carbon generators, cautious on high carbon intensity	Although this area is relatively well covered, Goldman Sachs scores marks for long-term (2020), generally quantitative analysis that tests various scenarios but also commits to a house view. The report takes a wide-ranging look at energy provision and its implications in Europe, including the role of clean tech, carbon capture & storage and nuclear energy. The authors are transparent and logical regarding their assumptions and how they arrive at their conclusions. At the company level, the risk of higher CO2 prices is used to forecast the NPV impact on the European utilities companies. Overall this is a highly-strategic look at the long-term future of the European utilities, with strong theme analysis that is supported by quantification and clearly-expressed views.	Jan-08	Europe	Graeme Moyses
Innovest	Integrated Oil & Gas Sector Report	This Innovest sector report covers a wide range of 'non-traditional' risk factors and value drivers for the integrated oil & gas sector. Areas such as strategic governance, environment, stakeholders and human capital are covered. A global selection of 28 companies is ranked according to social, environmental and combined ratings, as well as on a number of sub-factors. The report is notable for its comprehensive discussion of risk factors and a broad coverage of companies, including leading companies from emerging markets. But it stops short of assessing potential financial impacts of the described risk factors and proposing integrated company valuation approaches.	Oct-06	Multi-region	Christian Meade, et al.
JPMorgan	Obesity: Re-Shaping the Food Industry	This mainstream report on the impact of obesity on the US and European food industry provides a detailed analysis of the financially material impacts of obesity. The report contrasts the European pro-regulation vs. the US pro-litigation environment, and considers a range of consumer and regulatory drivers. Case studies are provided on the thesis of building competitive advantage through obesity-related R&D, and the report contains a section where other sector analysts (pharma, TV advertising, etc.) are asked to take a view on how the implications of obesity for the food, beverage & tobacco industry may have spillover consequences for their sectors. The qualitative analysis is very good, but there is little forward-looking quantitative analysis for the risks and opportunities identified in the report (almost all data are historical). Similarly company impacts are dealt with in a qualitative, short-term manner.	Jan-06	Multi-region	Arnaud Langlois, et al.
JPMorgan	Fortum: Well equipped to weather the weather	This mainstream company note on Finnish utility Fortum provides an excellent example of EFI mainstreaming. It mentions carbon opportunities, nuclear risks, risks related to a warming climate, regulatory and labour issues. Mid-term weather effects and carbon costs have been fully integrated into the DCF valuation.	Jan-07	Europe	Chris Rogers, et al.

Research provider	Title	Report summary	Date	Region	Author
Merrill Lynch	China, India & Brazil: Overpowering growth	ML teams based in Brazil, India and China have produced this excellent report on BRIC electric utilities. Its very long-term focus (2020 and beyond) and comprehensive coverage of regulatory, political, environmental, energy security and social trends is highly commendable. Three companies (Cemig, NTPC and Suzlon) have been valued in detail, others are covered more superficially.	Jan-07	Emerging & frontier markets	Joseph Jacobelli, et al.
Morgan Stanley	European Biodiesel: A Leveraged Play on Crude Oil Prices	This report considers the themes that should drive the European biodiesel market, including energy security, climate change, rising diesel consumption and an expected shortage of diesel refining capacity. The research provides analysis of the regulatory dimension across EU, long-range European biodiesel sales forecasts, and an analysis of margins along the biofuels value chain. Rich market analysis is accompanied by summary information from separate company notes on four companies that represent the analysts' top picks in the industry.	Jul-06	Europe	Luciano Diana, et al.
Oddo Securities	Air Transport: Human Resources: clear skies or turbulence ahead?	Oddo presents a comprehensive analysis of the human resources characteristics of a number of airlines and airport services companies. At the theme level, the report distinguishes between the characteristics of flag carriers and low costs, and describes qualitatively and quantitatively the risks posed by both endogenous and exogenous strike action. Individual companies are scored based on a proprietary human resources model, which is described in detail. Stock picks based on the HR model are compared with picks on traditional analysis using a 'Venn diagram' approach to give investment recommendations. Overall an innovative, systematic and transparent approach to a rarely-covered issue.	Apr-07	Multi-region	Jean-Philippe Desmartin, et al.
Société Générale	Electric Utilities: Prices to rise, aggravating distortions and raising risk of political intervention	According to SG analysts, Spain's refusal to allow CO2 costs to be passed on to consumers is one of many signs pointing to greater government / EU intervention in the operations of electric utilities (EU intervention in the case of E.On and the traditionally regulated French market are other examples). This regulatory risk is factored into the valuation of major European utilities by applying discounts on DCF and sum-of-the-parts valuations. This mainstream report represents one of the best pieces of research on regulatory risk seen by the EAI.	Mar-08	Europe	Adam Dickens, et al.
WestLB	Squaring the circle: Emissions standards in the car industry	Analyses the impact (including P&L effects) of existing and new regulation on the European Automobiles industry. Also evaluates the CO2 risks and opportunities on a per-company basis. The report splits the EFIs into those issues affecting those looking purely for financial return, and the 'SRI Perspective', with issues of interest to those looking also for environmental and social return.	Dec-05	Europe	Fredrik Westin

## Theme reports

Research provider	Title	Report summary	Date	Region	Author
CA Cheuvreux	Environmental Liabilities: Accounts to be rendered	The authors of this report review legal efforts to implement the 'polluter pays' principle and tougher accounting standards aimed at internalising environmental liabilities related to industrial pollution. Potential impacts on a range of industries and the relevance for both equity and fixed income investors are discussed. Produced in collaboration with specialist law and accounting firms, the report includes a comprehensive analysis of environmental and legal trends and assesses five highly-exposed sectors and 44 European companies in detail. As core risk indicators the ratios Environmental liabilities/Sales, Environmental liabilities/Total provisions and Provisions for environmental liabilities/EBITDA are used. The report also includes an interesting analysis of rising employee health and professional risk liabilities, on how companies manage liabilities through spin-offs and restructuring, and on the quality of reporting on environmental liabilities.	Jun-06	Europe	Stéphane Voisin, et al.
Citigroup	Avian Flu: Science, Scenarios and Stock Ideas	Detailed evaluation of macro-economic effects of various avian flu scenarios (currency impacts, employment, investor sentiment, deflation, etc.) and concomitant investment strategy to adopt (likely 'front-line' and 'second-line' winning and losing sectors, etc.). An ex-post SARS study is used as a proxy for macro-economic impacts (GDP impact, currency) and investment strategy. The report presents key sectors and regions likely to be positively and negatively affected by a pandemic, e.g. pharma, European airlines, Australian healthcare and insurance, Latin America. There are top-down estimates of revenue and earnings impacts on some key companies in the highlighted sectors and regions and some relative ranking. Overall a comprehensive and knowledgeable report in terms of the epidemiology and potential scenarios, but one that focuses on the likely short-term, market- / sentiment-driven impacts of an emerging EFI.	Nov-05	Multi-region	Robert Bonte-Friedheim, et al.
Citigroup	Climate Change and the ASX100: An Assessment of Risks and Opportunities	A comprehensive climate impact study, which covers not only the impact of rising carbon prices on ASX100 companies, but also the effects of potential physical impacts. The analysis distinguishes between two scenarios for carbon prices and two scenarios for physical impacts. Companies are rated based on CDP4 information in the following dimensions: customer risk/opportunity, climate risk/opp., carbon risk/opp., awareness, and resulting overall risk/opp. Additionally a distinction between near-term and longer-term effects is made. Even though it does not include financial analysis, this report offers useful information in the form of rankings.	Nov-06	Pacific	Bruce Rolph, et al.
CLSA	Nuclear Power: Asian nuclear renaissance	CLSA describes the renaissance in nuclear technology in Asia (particularly in China and India), which has been catalysed by a number of issues, including climate change, energy security and the military dimension. The research examines how investors in Asia-Pacific securities can play this renaissance, suggesting both Australian mining stocks and Japanese companies with exposure to nuclear engineering (preferring the investment opportunities in the former). The report contains a detailed and enlightening backgrounder on nuclear power generation and the related industries. Analysis of how the theme plays out in companies is largely qualitative.	May-06	Pacific	Anthony Wilkinson, et al.
ESN (CM-CIC Securities)	Europe-America: cultural and competitive duality	This is a highly-strategic report showing how cultural, economic and legal factors affect competitiveness of US and European sectors and companies. Includes interesting case-studies of US vs. European competitors, e.g. EADS-Boeing, or Carrefour-Wal-Mart. It also analyses some of the past transatlantic mergers and reasons for their failure or weak performance. Conclusions are drawn at the sector and macro level, e.g. the US is seen as leading in healthcare, consumer goods, industry and technology. The report is not strong on quantitative / financial company analysis, and only includes a selection of companies for case-study purposes.	Jul-05	Multi-region	François-Xavier Chevallier
JPMorgan	ESG in China: The issues, the effects and the cost to development	JPMorgan presents an ESG-dedicated report assessing key issues for China and their expected impact on the country's growth. The analysts cover not only familiar territory such as air pollution, energy and water shortages, but also social and governance issues, such as inequality, food inflation, healthcare and business ethics. The authors indicate sectors and companies likely to be affected by the issues (either positively or negatively). Although the depth of the analysis is not best-in-class, the coverage of issues, sectors and their constituent companies is exceptional.	Apr-08	Emerging & frontier markets	Wai-Shin Chan, et al.



Research provider	Title	Report summary	Date	Region	Author
Oddo Securities	In a 'bear' market, CG quality pays!	Oddo continues to build on the corporate governance model they brought to the market in 2006, which notably analyses companies differently depending on their ownership structure. The model is refined somewhat (factors that have not historically predicted share price performance are discarded). Historic prices for their high- and low-rated companies are examined to substantiate their claim that quality corporate governance yields outperformance in a bear market. The report also looks at convergence between CG and orthodox financial analysis in rising and falling markets (while acknowledging the differing time scales). Overall the analysis is systematic and quantitative. Current and historic scores for 130 European large caps are given in the appendices.	Apr-08	Europe	Léa Sombret, et al.
Société Générale	The India factor	This report assesses the long-term impacts of India's emergence as a global economic power. For each sector the most important impacts, market risks, timeframes, European company winners and losers, and emerging Indian companies are highlighted. The report has been co-produced with SG's SRI team and includes annexes highlighting the most important environmental, social, demographical and economic trends in India.	Mar-07	Multi-region	Alain Galène, et al.
Société Générale	Restructuring and job cuts: better light a candle than curse darkness	SG presents a rich and original analysis of many aspects of a theme that is rarely covered — the restructuring of major corporations. The authors analyse ex-post the economic 'sweet spot' on the scale between marginal and extreme restructuring, and assert that good corporate governance and stakeholder relations improve the likelihood of a successful restructuring outcome (although this thesis is not fully developed). Companies are ranked based on risk associated with upcoming / ongoing restructurings, which is then plotted against SG's combined CG and stakeholder relations scores, to give a 2 x 2 matrix. Orthodox financial recommendations are then mapped onto the highest and lowest quartiles to give the best and worst plays on the theme.	Oct-07	Europe	Marie-Gabrielle Lanne-grace, et al.
UBS	Product Recalls & Difficult Credit Markets: What's the Connection?	A highly-strategic and innovative analysis of the links between confidence of the market in a company, its disclosure levels, management quality, and valuation. The report takes China-related product recalls and the Northern Rock case as a starting point to show that when confidence is high, markets tend to ignore transparency. Once confidence is lost, the absence of confidence and lack of transparency feed on each other, especially when supply chain issues are involved. Using correlation analysis, the authors show a weak link between ESG disclosure quality and financial performance. The report also includes a review of academic literature assessing the link between environmental and health events and share prices.	Sep-07	Multi-region	Julie Hudson, et al.
UBS	Need to Know: Reacting to Climate Change: Japan: opportunity and risk	This report provides a comprehensive analysis of expected impacts of climate change and related policies on the Japanese economy. The exposure of sectors and major companies is quantified based on Trucost and Nikkei data, providing input for changes in asset allocation or stock picking by the buy side. A detailed sector-by-sector analysis shows that Japanese companies lead the field in a number of climate change mitigation technologies: auto power trains, advanced recycling and energy saving technologies, environmental technology and others. The authors highlight a series of companies particularly well positioned to benefit from the described trends, and also explicitly mention companies to avoid.	Apr-08	Pacific	Julie Hudson, et al.

# Appendices

## EAI members

### Full members

- Allianz Global Investors France  
(France)
- APG Investments  
(Netherlands)
- AXA Investment Managers  
(France)
- BNP Paribas Asset Management  
(France)
- CPP Investment Board (Canada)
- Generation Investment Management  
(UK)
- Governance for Owners  
(UK)
- Hermes Pensions Management  
(UK)
- Investec Asset Management  
(South Africa)
- La Banque Postale Asset Management  
(France)
- Mn Services  
(Netherlands)
- PGGM  
(Netherlands)
- RCM  
(UK)
- Robeco  
(Netherlands)
- SNS REAAL Groep  
(Netherlands)
- Universities Superannuation Scheme  
(USS) (UK)

### Associate members

- Bedrijfstakpensioenfond Metalektro  
(PME)
- BT Pension Scheme  
(UK)
- California State Teachers' Retirement  
System (CalSTRS)  
(USA)
- Calvert Group  
(USA)
- Comité syndical national de retraite  
Bâtirente  
(Canada)
- HESTA Super Fund  
(Australia)
- London Pensions Fund Authority  
(UK)
- MetallRente  
(Germany)
- Mistra Foundation  
(Sweden)
- New York City Employees'  
Retirement System (NYCERS)  
(USA)
- Pensioenfond Metaal en Techniek  
(PMT)  
(Netherlands)
- Trades Union Congress (TUC)  
Superannuation Society  
(UK)
- UniSuper  
(Australia)
- VicSuper  
(Australia)

## Guidance on extra-financial issues

Extra-financial issues are probably best described as fundamentals that have the potential to impact companies' financial performance in a material way, yet are generally not part of traditional investment analysis. Their low coverage can result from the often qualitative nature of the issues (making them difficult to implement in financial analysis), or from the fact that they often have longer-term horizons than the current focus of mainstream financial analysis. They tend to relate to issues related to the strategic positioning of companies, their overall management quality and quality of risk management. Extra-financial issues may be specific to a company, an industry or cut across several industry groups.

Extra-financial issues generally have one or more of the following characteristics:

- They tend to require some degree of innovation from the researcher in order to be quantified in monetary terms (e.g. corporate governance, intellectual capital)
- They relate to externalities not well captured by market mechanisms (e.g. environmental pollution)
- They relate to wider elements of the supply chain (e.g. suppliers, products and services)
- They are the focus of public concern (e.g. GMOs)
- They have a medium to long-term horizon (e.g. climate change impacts)
- The policy and regulatory framework is tightening (e.g. greenhouse gas emissions)

### Examples of extra-financial issues (EFIs)

EFIs relevant to investment decisions differ across companies, sectors and regions. The following are examples of issues with a broad range of impacts on companies and other issuers of securities:

#### Environmental issues

- Climate change, water scarcity — related risks and opportunities
- Local environmental pollution and waste management
- New regulation expanding the boundaries of environmental product liability
- New markets for environmental services and environmentally-friendly products

#### Social issues

- Workplace health and safety
- Knowledge and human capital management
- Labour and human rights issues within companies and their supply chains
- Government and community relations (notably where there are operations in developing countries)

#### Governance issues

- Board structure and accountability
- Accounting and disclosure practices, transparency
- Executive compensation
- Management of corruption and bribery issues

More broadly, the EAI also aimed to support innovation in research covering other material non-traditional issues and a long-term focus. An example of research that was deemed eligible: M&A research covering 'non-traditional' aspects such as long-term competitive market position, cultural fit of the two companies, the marriage of two different corporate governance regimes, etc. Conversely, a very detailed report on the near-term product pipeline of a pharmaceutical company would generally not have been eligible for the EAI evaluations (such reports were considered to be high-quality mainstream research that does not cover a 'non-traditional' aspect).

## Qualifying research

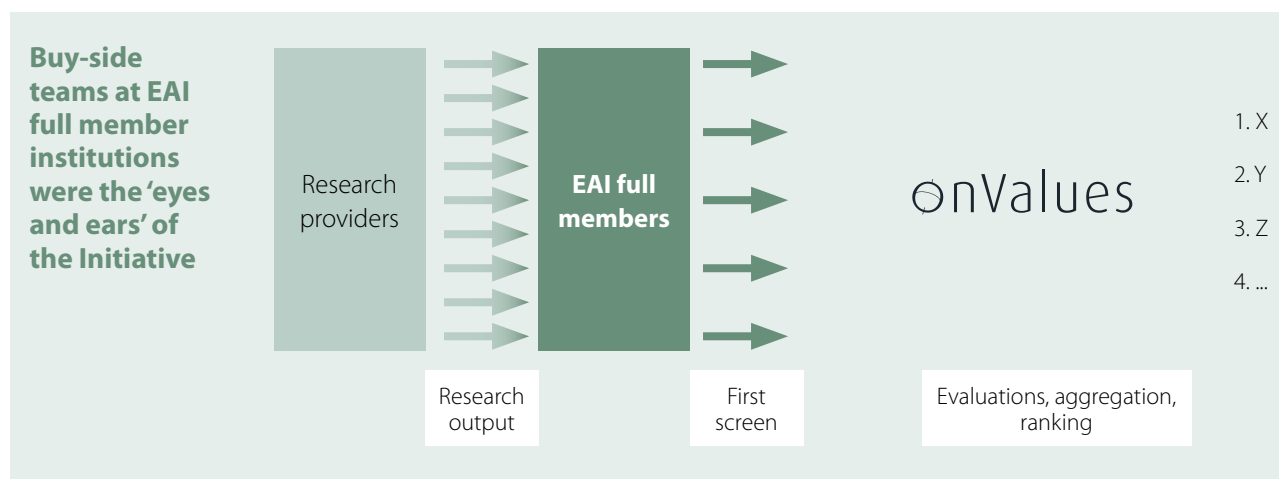
The following criteria were used to determine whether research was eligible for the EAI evaluations:

- Broadly: research available to all investors through normal commercial channels was eligible
- Only published outputs were considered (not portals, ad hoc responses or other elements of the service furnished to clients by research providers)
- Bespoke research / consultancy was NOT eligible

## Evaluation methodology

EAI evaluations were structured along the following steps:

1. EAI full members selected the research outputs that their mainstream analysts considered most useful. Members assigned a simple relevance rating to each report submitted. These reports were included in the evaluation universe
2. onValues performed an initial screening of the universe for eligibility and consistency with the goals of EAI (minimum EFI content)
3. Each eligible report was assessed in detail, according to the criteria described below. For each research report the score was calculated on a percentage scale by multiplying its score for quality with its score for coverage
4. The scores at the report-level were aggregated to obtain a total score for each research provider. Research providers were ranked according to their total score



From the baseline evaluation in 2004 through to the eighth evaluation in June 2008, the Initiative used its cumulative experience to make minor adjustments to the evaluation methodology. These changes were made by onValues, the consultant, in close consultation with a group of buy-side end-users of research selected from EAI members.

The five criteria used for the evaluations were as follows:

1. Scope of extra-financial issues covered
  - 1.1. Coverage of relevant extra-financial issues
2. Investment relevance of sector and issue analysis
  - 2.1. Thoroughness of top-down analysis
  - 2.2. Quantitative modelling of sector impacts
  - 2.3. Allocation to both long- and short-term horizons
3. Company analysis and integration into financial analysis
  - 3.1. Analysis of EFI impacts on company-specific investment value drivers
  - 3.2. Integration into securities valuation
  - 3.3. Ranking of companies, integration of EFI analysis into securities recommendations

4. Coverage of research universe
  - 4.1. Coverage of relevant sectors
  - 4.2. Coverage of global investable universes
5. Overall presentation and originality
  - 5.1. Includes an assessment of the user-friendliness, originality and transparency of research outputs

It should be noted that from the December 2006 evaluation the sole burden for selecting the research outputs to be included in the evaluation universe fell on EAI members. That is to say that the call from onValues to research providers for supplemental research was abolished. This design feature meant that in order to perform well in the EAI evaluations the research provider had not only to produce high-quality 'enhanced' research, but also to bring that research to the attention of buy-side analysts and portfolio managers. As such the research selection by EAI members had the dual effects of ensuring that the EAI's scoring was strongly based on members' collective views and of sensitising both the investment management and research communities to new research developments.

### Research providers featured in EAI evaluations

■ 13D Research	■ ING
■ ABN AMRO	■ Innovest
■ Ambrian	■ Jantzi Research
■ Baird	■ JPMorgan
■ Bank of America	■ Keefe, Bruyette & Woods
■ Bear Stearns	■ Lehman Brothers
■ Bernstein	■ Macquarie
■ Blackmont Capital	■ Merrill Lynch
■ BMO Nesbitt Burns	■ Morgan Stanley
■ CA Cheuvreux	■ Nomura
■ Canaccord Capital	■ Numis
■ Cazenove	■ Oddo Securities
■ CFRA	■ Pali Capital
■ CIBC	■ RBC Capital Markets
■ Citigroup	■ Redburn Partners
■ Clear Capital	■ Société Générale
■ CLSA	■ Standard Chartered
■ Collins Stewart	■ TD Securities
■ Credit Suisse	■ Thomas Weisel Partners
■ Deutsche Bank	■ UBS
■ Dresdner Kleinwort	■ Vigeo
■ ESN – European Securities Network <sup>13</sup>	■ Wachovia Securities
■ Exane Paribas	■ WestLB
■ Friedman Billings Ramsey	
■ Goldman Sachs	
■ HSBC	
■ Independent Minds	

*Note: providers are shown  
in alphabetical order*

<sup>13</sup> ESN partners that featured in EAI evaluations include CM-CIC Securities, equinet and Van Lanschot

## Research providers recommended by EAI evaluations

### Dec-04

- Deutsche Bank
- Dresdner Kleinwort
- Goldman Sachs
- HSBC
- Morgan Stanley
- UBS
- WestLB
- ABN AMRO (*also noted*)
- Citigroup (*also noted*)
- ESN (CM-CIC Securities) (*also noted*)

### Jun-05

- Bernstein
- Dresdner Kleinwort
- ESN (CM-CIC Securities)
- UBS
- Deutsche Bank (*also noted*)
- Goldman Sachs (*also noted*)

### Dec-05

- Bernstein
- CLSA
- Dresdner Kleinwort
- ESN (CM-CIC Securities)
- Goldman Sachs
- JPMorgan
- UBS
- WestLB

### Jun-06

- Bernstein
- Citigroup
- CLSA
- Deutsche Bank
- Goldman Sachs
- JPMorgan
- Morgan Stanley
- Oddo Securities
- UBS

### Dec-06

- Bernstein
- CA Cheuvreux
- Citigroup
- CLSA
- Deutsche Bank
- Goldman Sachs
- Innovest
- Morgan Stanley
- Oddo Securities
- Société Générale
- UBS

### Jun-07

- CA Cheuvreux
- Citigroup
- JPMorgan
- Merrill Lynch
- Morgan Stanley
- Oddo Securities
- Société Générale

### Dec-07

- CA Cheuvreux
- Citigroup
- Credit Suisse
- Deutsche Bank
- JPMorgan
- Oddo Securities
- UBS
- Goldman Sachs (*also noted*)
- Société Générale (*also noted*)

### Jun-08

- Citigroup (*outstanding*)
- Goldman Sachs (*outstanding*)
- Société Générale (*outstanding*)
- CA Cheuvreux
- Credit Suisse
- JPMorgan
- Oddo Securities
- UBS



