United States House of Representatives Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, & Capital Markets
Written Statement of
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Chairwoman Maloney, Ranking Member Huizenga and distinguished members of the subcommittee. I appreciate the invitation to appear before you this afternoon to talk about the proposed legislation that will provide greater disclosure of material information for investors.

I am an investment manager who conducts company research to manage equity portfolios on behalf of our clients. One of the key factors in estimating the value of an equity security has traditionally been the analysts' ability to understand and forecast a company's earnings. During my career in the industry, though, I have observed that the accuracy of forecasted earnings has diminished, and, subsequently, the role of forecasting earnings has become less important in estimating a stock's valuation. I believe that the increasing role played by intangible assets in modern corporations is at the heart of this problem. Corporate investment in traditional tangible assets such as factories, machinery, and inventory has dropped from 15% of gross added value in 1977 to 9% by 2014, while corporate investment in intangible assets such as research & development, brands, media content, and business processes increased from 9% to 14% of added value over the same time frame.[1] The critical issue is that the role of intangible assets in driving earnings has increased, but accounting statements, rules, and required disclosures have not kept pace.

My interest in environmental, social, and governance (ESG) issues is based on the discovery that these items may provide material information, tangible and intangible assets, to make the best investment decisions on behalf of our clients. First, allow me to define material information or materiality, it is information that a reasonable shareholder would consider is important in deciding how to vote a proxy, purchase or sell a security. Therefore, my perspective is the information that we will discuss today is material to a reasonable shareholder. If you agree that this information is material to shareholders, then, it follows that this information should be shared with all shareholders and investors resulting in the Securities Exchange Commission to amend the reporting rules.

Disclosure of Political Risk

The legislation requesting disclosure of political contribution addresses a relative new material factor in the selection of securities. We have found in our research that political risk can be measured, and this political risk impacts the pricing of securities. The 2017 KPMG global CEO outlook survey reports that more than half of the interviewed CEOs believe that the uncertainty of the current political landscape has a larger impact on their business than in the past. Approximately 70% of the CEOs have been taking steps to address the political risk to protect shareholder value. These firms and their executives view political donations as an effective tool for corporate political activism and therefore donate sizable amounts to political candidates. Since the Citizens United v. FEC Supreme Court decision, corporate political action committees (PACs) campaign contributions have increased. The total campaign contributions raised by corporate PACs exceeded $2.2 billion for the 2016 election cycle compared to $630 million in the 2000 election cycle, an increase of 250%.[2]

As investors, how can we measure a firm's political risk? One study uses the firm's quarterly earnings conference calls and measures the share of the call devoted to the discussion of political risk. The information shared on the conference calls provide different information than what is included in the quarterly financial statement reports. The study indicates that as the share of political comments of the conference call increases that this serves as a measure for political risk. Typically investment models predict that an increase in any kind of risk, and therefore an increase in the firm's political risk may trigger an increase in the firm's stock return volatility. The study measured risk across several different categories to include; health, economic policy & budget, environment, security & defense, tax policy, trade, technology & infrastructure, and political process. The study finds that as firms face higher political risk in these categories; subsequently, they will donate more to political campaigns that address these risks.[3]

The ability to evaluate conference calls may not be available to the typical investor. The Federal Election Commission provides public access to federal campaign contributions; however, there are limited sources for contributions to state and local level. Therefore, most investors cannot fully measure political risk.

However, if the correlation between a firm's political risk and political contributions is positive, then, the political contribution may serve as a proxy for political risk. Based on our research, we have found that political contributions serve as an active strategy to reduce a corporation's political risks. In fact, a number of listed firms include a discussion of political contributions in their sustainability reports.

We have evaluated the news related to political influence to determine if this information is material to stock performance. We found that the majority of large corporations' returns were impacted as news of political and/ or regulatory risk increases, the stock prices decline. Based on our research, we have found that political contributions, as a proxy for political risk, is material in making investment decisions.

Disclosure of Climate Risk

The legislation requesting disclosure of climate risks addresses a complex material impact on security pricing. This risk is difficult to measure for several reasons since the risk parameters may be mispriced due to shortcomings in the available information.

I will not address the science or legal issues regarding climate risk. As an investor, I attempt to model risk factors and I treat climate risk as a factor. First, a definition of climate risk is important. I view climate risk as the impact on a corporation's financial performance based on the current and future effects of climate change – which can be referred to as physical risk and transitional risk. The physical risk addresses damage based on the impact of carbon emissions on the environment. An example is the impact on insurance companies that have to underwrite coverage for properties in coastal areas that are experiencing an increased number of catastrophic flooding and storm events.

The transitional risk is the risk from moving the current emission levels to a future of lower emission levels. An example is the impact on energy firms that are focused on fossil fuels, which may see reduced revenues as the preference for alternative energy sources increase.

Predicting the timing of the impact of climate change is difficult; however, we have observed the change in firm behavior related to climate change has already started to occur. Therefore, I will explain as an investor how we measure the climate risk for our clients and how the proposed legislation will assist us in this process.

The initial step is to measure the baseline carbon emissions. This measures the total amount of greenhouse gases that are emitted into the atmosphere directly by the corporation, indirectly by purchasing energy, and other indirectly outsourced activities. In order to compare across firms, we measure the carbon emissions as metric tons per $1 million of firm's revenues. This is referred to as carbon intensity.

We analyzed 3000 listed U.S. firms that are members of the Russell 3000 Index which represent about 98% of all U.S incorporated equity securities. A number of corporations are voluntarily providing material emission information to investors. The number of firms that are reporting their baseline or current carbon emissions is approximately 417 or 14% of firms. Among the 186 energy firms we evaluated, which may be most impacted by climate risk, 33 or 18% report their current level of emissions.

A further step is to identify stranded assets; this is similar to the treatment of impairment of assets and takes into account regulatory, economic, and physical effects. Currently, stranded assets are fossil fuel supplies that will have a lower economic return as a result of the transition to a low carbon economy sometime in the future. The number of firms that are reporting their emission targets is approximately 363 or 12% firms. Among the 186 energy firms that we evaluated, 7 or 4% have included emission reduction target policies. Several of these firms use climate change scenario analysis to forecast the impact on their financial performance which is a material issue to shareholders and investors.

Many firms have turned to organizations such as the Global Reporting Initiative to provide guidelines. The Global Reporting Initiative (GRI) is an international independent standards organization that works with corporations and governments to understand and communicate the impacts of climate change. Also, a number of firms have used peer reviews, media content, and thought leaders in sustainability to develop issues that are material to their business model. In addition, firms have requested that the Stakeholder Committee selected by CERES review their sustainability reports. CERES is a sustainability nonprofit organization working with investors and corporations to address climate change, water scarcity, pollution, and inequitable workplaces.

If listed firms are required to report their current level of carbon emissions, stranded assets, and transition plans this will provide shareholders with material information to evaluate the physical and transition risks.

We continue to evaluate methods to price the environmental impact on stock prices.
One method is based on the news around environmental issues to include carbon emissions and air quality. We have found that those firms with positive environmental news compared to firms with negative environmental news outperform one year later. Based on our research, we have found climate risk to be material item in making investment decisions.

Disclosure of Tax Avoidance Risk

The amount of corporate income tax a company pays is material to its profitability. Investors therefore seek to understand the extent to which future cash flows are based on artificial tax structures. These artificial tax structures may be challenged in the future which will impact the firm's stock valuation. Furthermore, corporate tax avoidance activities, while perfectly legal, may suggest underlying regulatory or reputation risks

A study by the Principles of Responsible Investment (PRI), a United Nations supported organization, assessed the levels of corporate income tax disclosure at 50 large multinational companies in the healthcare and technology sectors. The study found insufficient explanation and data to test corporate commitments around avoiding profit shifting. Profit shifting is one of the primary methods to avoid the payment of taxes. Typically, corporations did not provide explanations regarding their operations in low tax jurisdictions where business operations were not apparent. The corporations' disclosures lacked any country level data on common economic activity indicators such as revenue, profits, employee numbers and taxes paid. The U.S. listed firms are required to report only foreign and domestic taxes.[4]

As an investor, it is important to know that the firm's tax practices of our portfolio companies can withstand stakeholder scrutiny and potential regulatory changes. As corporate tax regimes are reconsidered across countries to avoid revenue loss to tax avoidance, multinational companies will face increased pressure to defend their tax-related transactions and/or may see new forms of taxation applied. Also, if corporations disclose country by country tax rates, this will allow investors to determine the appropriate effective tax rate. Most corporations report their domestic effective tax rates in their quarterly reports which may not capture their global effective tax rate.

As investors, we have been unable to evaluate the full impact of tax avoidance risk given the lack of country by country tax reporting. By providing this detailed information, it will increase transparency and accountability.

Companies pursuing aggressive tax avoidance activities may be indicative of management's preference for high risk strategies. One case study involves a foreign based international bank that trades on the U.S. Exchange. This bank operated a tax avoidance division. The tax avoidance division generated more than $1 billion annually from 2007 to 2011. This operation was disclosed in 2012 and the tax authority levied a $300 M tax penalty for the most recent year of the operation. Since the tax penalty in 2012, the firm has experienced other issues and has lost over 45% of its stock value. Therefore, based on our research, tax avoidance risk is a material issue.

Disclosure of Human Rights Risk

The legislation requesting disclosure of human rights and value chain risks are material factors in the selection of securities. It is easy to understand that news of human rights violations can impact the reputation and the stock price of a corporation.

A number of corporations are voluntarily providing material human rights information to investors. The number of firms in the Russell 3000 that have a human rights policy that seeks to avoid child, forced or compulsory labor is approximately 906 or 30% of firms. Also, a number of firms have policies that use human rights criteria in the selection and monitoring of its suppliers or sourcing partners is approximately 720 or 24%.

We have found in our research that news on human rights can be measured and this risk impacts the pricing of securities. It should be no surprise that the firms in the consumer related sectors such as financials, consumer goods and services are significantly impacted by both positive and negative news related to human rights. We have found that those firms with positive human rights media news compared to firms with negative human rights news outperform one year later. Based on our research, we have found human rights risk to be material item in making investment decisions.

Sustainable Finance Advisory Committee

We support the creation of a Sustainable Finance Advisory Committee to advise the Securities Exchange Commission (SEC) on environmental, social, and governance issues (ESG). The committee will assist the Commission in evaluating the evolving issues related to ESG materiality and capital markets.

Thank you for your time. The oversight work of this Subcommittee is a critical responsibility and I welcome any questions that you may have.

References

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[4] Ravishankar, V.. Evaluating and Engaging on Corporate Tax Transparency: An Investor Guide (2018) www.unpri.org.