Corporate Sustainability Index ISE

THE VALUE OF ISE

Main studies and investor perspective

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BM&FBOVESPA
The New Exchange

FGV
GVces
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Summary

Foreword

The idea of creating a Corporate Sustainability Index (ISE) for BM&FBOVESPA came up almost nine years ago, and materialized when it was launched in November 2005. Since then, the index has established itself as a key driving factor for companies seeking a business model that can contribute to sustainable development.

In 2010, when strategic goals were defined for the ISE over a five-year timeframe, the ISE's Deliberative Board (CISE), BM&FBOVESPA and Gvces committed themselves to work on raising the number of companies participating in this process, increasing the volume of invested funds and products linked to the index, and turning it into a benchmark for sustainable and responsible investments, among other commitments. These goals were defined based on a series of discussions with the key ISE stakeholders and, in order to reach such goals, BM&FBOVESPA ordered this study to expand corporate participation and enhance investor engagement.

Along this path, the benefits of taking part in this process are increasingly clear to companies. The ISE stands out among its peers since it carries a collective process for improving its main company evaluation tool, which consists of a basic questionnaire available through inquiries, public hearings, workshops or other ways of improving and revising the questionnaire. This process imparts legitimacy to the adopted methodology and better reflects society's demands for corporate sustainability.

From a corporate perspective, the value of participating in voluntary sustainability initiatives is perceived through intangible gains afforded by such experiments, such as in reputation and experience sharing within the business community, or through tangible gains, which are still little known, but have been addressed in studies that focus on market value, the relationship between financial performance and social and environmental performance or the financial market's response to the actions of "more sustainable" companies.

In our conviction that the companies participating in the ISE process are at the forefront of dealing with a topics so complex as sustainability, we feel there is a need for strengthening the participation of a key player in this scenario – the institutional or retail investor.

To investors, sustainability represents an opportunity as the Sustainable and Responsible Investment (SRI) market grows and substantiates a demand for companies whose activities can be sustained in the long run by reaping environmental, social and economic gains.

We note that there is still a long way to go towards strengthening and consolidating the market mechanisms capable of rendering the new economy feasible. To do so, we place our chips on engaging and approaching institutional investors to help them fulfill an agenda driven by consolidated international initiatives, such as the Principles for Responsible Investment (PRI) or, under construction, such as the Global Initiative for Sustainability Ratings (GISR).

This study has been prepared with the aim of bringing together the main research lines that seek to identify and convey the value of participating in initiatives like the ISE. This document is structured on three major fronts. On the first front, we conducted a survey to collect the main data on SRI trends in the two largest market niches: Europe and the United States, besides results from an MIT research study conducted among executives on the value of sustainability in the current market. Next, we carried out a non-exhaustive survey on academic studies that seek to identify the intangible and tangible gains achieved by companies through their participation in the ISE or related initiatives. Finally, we present the results of a survey done with major Brazilian pension funds aimed at investigating the knowledge of the ISE and how it could be used in their analysis and decision-making process.

We cannot be sure about the direction towards which the world and the international economy will be moving in the future, but surely they will be different from today, and those companies and investors better prepared for that future will reap the benefits. We still have a long way to go, but we hope to contribute to the construction of this new road leading to sustainable development.

Enjoy the reading!

Roberta Simonetti
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1. Introduction

Sustainable and Responsible Investment (SRI) is defined by the European Sustainability Forum (Eurosif) as an investment process whose financial goals are linked to the investor's concerns and values regarding Environmental, Social and Governance (ESG) related issues.

The stock market plays a key role in promoting the adoption of ESG criteria by investors, thereby encouraging SRI growth. This driver is reflected in the increasingly significant number of existing sustainability indices, which according to the survey "Sustainable Stock Exchanges: Real Obstacles, Real Opportunities" has now exceeded the mark of 50 indices in various stock exchanges around the world.

In 2005, the Corporate Sustainability Index (ISE) was the world's fourth index of its kind to be launched. It was a pioneering initiative in Latin America. The ISE combines Brazilian companies listed on BM&FBOVESPA with the best corporate management practices and best strategic alignment with sustainability, and represents an incentive for companies seeking economic development with social outreach and respect for the environment, while also serving as a market driver for Sustainable and Responsible Investment in Brazil. The ISE's mission is to stimulate companies into adopting the best corporate sustainability practices and support investors in making sustainable and responsible investment decisions.

Thus, the ISE seeks to differentiate between companies based on sustainability aspects by creating an investment environment consistent with the demands of contemporary society, encouraging the creation of responsible investment funds to become their primary benchmark and also a benchmark for corporate performance evaluation. According to Biderman, Brito & Monzoni (2006), the ISE seeks "to detect a company's ability to generate value and the risk level associated with its performance in different sustainability settings (…). It is hoped that the ISE will serve as tool for raising corporate and investor awareness."

The ISE and other SRI funds are a part of a global trend identified in the studies undertaken by the Sustainable Investment Forum (SIF) for Europe and the United States, by the Massachusetts Institute of Technology (MIT) in the survey "Sustainability Nears a Tipping Point," and by Principles for Responsible Investment (PRI) reports.

Those studies point out an SRI market growth of 22% in the United States between 2009 and 2012, or 486% since it was first measured in 1995. At present, SRI represents 11.3% of all assets under management in the U.S. market. Institutional investors, such as pension funds, are increasingly demanding sustainability performance data, which underscores the need for accurate metrics to be provided. Foremost among the key benefits of investing in sustainability is its link to innovation, according to the MIT report.

In Brazil so far there are no surveys similar to those conducted by the SIF to identify the amount of SRI assets. However, a progress in this type of investment can be seen based on the significant number of PRI subscribers located in Brazil, which represents 90% of Latin American subscribers (PRI Progress Report, 2011).

With the purpose of understanding how the ISE has contributed, or might contribute, to investment analysis and the kind of value this process might generate for investors, companies and society alike, a study was carried out in a partnership between the PRI and the Brazilian Association of Private Pension Fund Companies (ABRAPP) with major Brazilian Pension Funds – investors who, by nature, appreciate long-term returns.

This study seeks to evaluate two perspectives in the process of furthering SRI in Brazil - a corporate and an investor perspective. Initially, the main surveys conducted to assess value generation for corporations and investors will be mapped out considering their participation in voluntary sustainability initiatives and their results, along with a first investigation on Pension Funds to understand how these gains are perceived by investors and the efforts made by companies seeking to set themselves apart from the rest by joining the ISE portfolio.

2. Key Trends

The latest reports released by the European Sustainable Investment Forum (Eurosif) and United States Sustainable Investment Forum (US SIF) as of 2012 (EUROSIF, 2010 and 2012, and US SIF, 2010 and 2012) show that the SRI segment has been growing at a fast pace and has performed better than traditional investments. While usually greater profitability comes with greater risk, those studies also demonstrate that sustainable and responsible investments are less volatile than other types of investment, which gives SRIs a higher Sharpe ratio, i.e., their return over risk ratio is higher.

According to Eurosif (2010), the 2008 global financial crisis had a positive impact on SRIs, as the need for integrating ESG risks into economic and financial risks became clearer. François Passant, executive director of Eurosif 2012, points out the continuous sophistication of a rapidly growing market with several participants adopting different responsible investment strategies. He says that "this sophistication also highlights the need for enhanced transparency and clarification of practices. It also surely supports our conviction that SRI has the potential to bring some answers to the growing concern by society and policy-makers about reconciling finance with long-term, sustainable growth." The demand for greater disclosure, therefore, echoes in the SRI principles, and also in such events as BP's oil spill, showing investors how social and environmental risks have significant and long-lasting financial impacts.

Investors have adopted different responsible investment strategies, sometimes in conjunction with other investments. According to Eurosif (2012), the main strategies adopted by asset managers are:

- Sustainability themed Investment: Investment in themes or assets linked to the development of sustainability. Thematic funds focus on specific or multiple issues related to ESG.
- Best-in-Class Investment Selection: Approach where leading or best-performing investments within a universe, category, or class are selected or weighted based on ESG criteria.
- Norms-based Screening: Screening of investments according to their compliance with international standards and norms.
- Exclusions of specific investments or classes of investment from the investible universe such as companies, sectors, or countries.
- Integration of ESG Factors in Financial Analysis: The explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and investment decisions based on a systematic process and appropriate research sources.
- Engagement and Voting on Sustainability Matters: Engagement activities and active ownership through voting of shares and engagement with companies on ESG matters. This is a long-term process, seeking to influence behavior or increase disclosure activities.
- Impact investments: Impact investments are investments made into companies, organizations and funds with the intention of generating social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market-to-market rate, depending upon the circumstances.

Eurosif states that the SRI strategies analyzed have grown more significantly than the traditional asset management market. The norms-based screen was the fastest growing strategy, with an estimated amount of €2.3 trillion in assets under management, which represents a 137% growth over 2009. That result shows that international conventions and treaties can have an actual impact on financing decisions.

Assets under management adopting Exclusion of Specific Sectors, Companies, or Practices and Best-in-Class strategies experienced growth rates of 119% and 113%, respectively.

With a growth rate close to 17%, the Engagement and Voting strategy is currently undergoing a consolidation stage in Europe, and is starting to be adopted in countries such as Spain and Italy. The Integration strategy showed a 14% growth rate from 2009 to 2011.

SRI market growth by strategy:

Europe (14 countries) €Mn	2009	2011	CAGR
Sustainability themed	€ 25,361	€ 48,090	37.7%
Best in Class/Positive Screen	€ 132,956	€ 283,206	45.9%
Norms-based screening	€ 988,756	€ 2,346,308	54.0%
Exclusions	€ 1,749,432	€ 3,829,287	47.9%
Engagement/Voting	€ 1,668,473	€ 1,950,406	8.1%
Integration	€ 2,810,506	€ 3,204,107	6.8%

Source: Eurosif 2012

The Eurosif 2012 SRI Study also shows that European investors are increasingly adopting investment policies with Exclusion of sectors strategies. Data from the study indicate that almost 50% of all assets under management in Europe have policies requiring the exclusion of companies involved in the manufacture of certain types of weapons, most commonly those subject to the International Convention on Cluster Munitions.

In the United States, between 2010 and 2012, SRI assets grew more than 22%, reaching US$3.74 trillion. The SRI market in the United States today accounts for 11.3% of the US$33.3 trillion in total assets under management mapped out. From 1995, when the US SIF first estimated the size of the U.S. sustainable and responsible investment market, to 2012 the SRI grew by 486%, while total assets under professional management in the United States, according to Thomson Reuters Nelson estimates, grew by 376%. This means that today more than one out of every nine dollars under professional management in the U.S. market is invested according to sustainable and responsible investment strategies.

Fig. A: Sustainable and Responsible Investing in the United States 1995–2012

	1995	1997	1999	2001	2003	2005	2007	2010	2012
ESG Incorporation	$166	$533	$1,502	$2,018	$2,157	$1,704	$2,123	$2,554	$3,314
Shareholder Resolutions	$473	$736	$922	$897	$448	$703	$739	$1,497	$1,536
Overlapping Strategies	N/A	($84)	($265)	($592)	($441)	($117)	($151)	($981)	($1,106)
TOTAL	**$639**	**$1,185**	**$2,159**	**$2,323**	**$2,164**	**$2,290**	**$2,711**	**$3,069**	**$3,744**

Source: US SIF 2012

The assets and numbers of funds that incorporate ESG criteria in the United States have continued to grow since 2007. Between 2010 and 2012, such assets increased by 78%, from US$569 billion to US$1.01 trillion among different ESG funds.

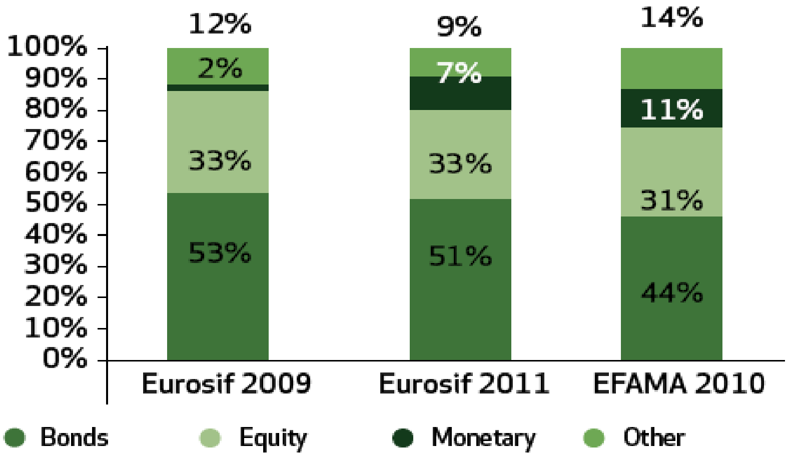
Fig. B: Investment Funds Incorporating ESG Factors 1995–2012

	1995	1997	1999	2001	2003	2005	2007	2010	2012
Number of Funds	55	144	168	181	200	201	260	493	720
TOTAL NET ASSETS *(In Billions)*	$12	$96	$154	$136	$151	$179	$202	$569	$1,013

SOURCE: US SIF Foundation.
NOTE: ESG funds include mutual funds, annuity funds, closed-end funds, exchange-traded funds (ETFs), alternative investment funds and other pooled products, but exclude separate account vehicles and community investing institutions.

Source: US SIF 2012

In Europe, SRI is allocated primarily to bonds (51%) and equity (33%), as shown in the chart below – a scenario similar to 2009, according to the Eurosif report. The volume growth of bond investments is, in part, due to a growing supply and the application of sustainability ratings, as well as to the adoption of particular methodologies by asset managers. As compared to general market data for 2010 compiled by the European Fund and Asset Management Association (EFAMA), SRI investors noticeably prefer to allocate their investments to bonds rather than to more exotic assets.



Source: Eurosif (2012)

In Europe, the investment funds segment sustained the heaviest losses during the 2008 financial crisis but, nonetheless, the total amount allocated to SRI investment funds experienced less of a reduction than assets invested in traditional funds (EUROSIF, 2010). In the United States, from 2007 to 2010, the number of investment funds incorporating ESG criteria to their analysis grew by 90%, from 260 to 493, and accounted for a 182% increase in total assets, from US$202 billion to US$569 billion (US SIF, 2010).

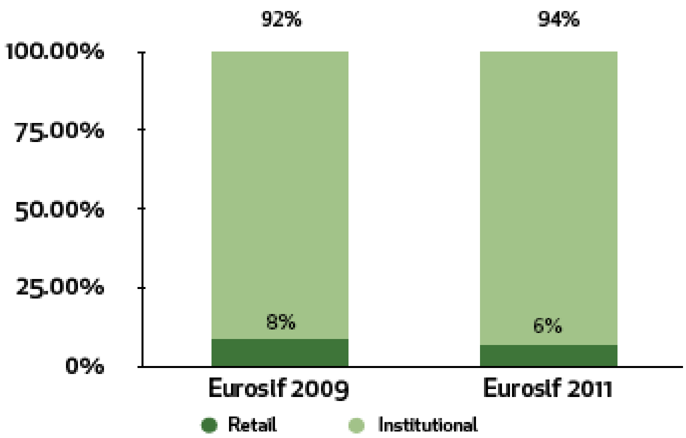
The US SIF 2012 Study identified 301 different alternative investment vehicles – such as hedge, private equity and venture capital funds – which together add up to US$132 billion in assets under management. This investment market segment, which incorporates ESG criteria, grew by 250% in assets since 2010, when they totaled US$37.8 billion.

The Eurosif report identified a growing interest in microfinance funds, which have a long-term perspective and are inherently concerned with ESG. The report also pointed out the need for investors to diversify their investments, so there is a demand, but supply also needs to be increased.

The key drivers for SRI demand worldwide still are institutional investors, which account for 94% of SRI assets in Europe. Foremost among them are public and private pension funds, universities, and insurance companies. Regulation is currently perceived as the second major factor in SRI growth over the next few years. This is due to investor and financial market behavior and to European Union legislators, since many regulators have taken action to protect Europe against future financial turbulence and get economic growth back on track.

In addition to institutional investors and regulators, international initiatives and retail investors are also major driving factors for the growth of SRI market demand worldwide (EUROSIF 2012).

SRI Investors by Type:



Source: Eurosif (2012)

The growth seen in the Eurosif 2012 Study is attributable to a small number of large investors or managers adopting a certain strategy for all or a substantial part of their assets. Experience shows that a few pioneers can strongly impact the market and lead to a proliferation of certain strategies.

SRI growth, which shows no signs of slowing down, indicates that Europe's asset management industry is still supportive of sustainable and responsible investment in its various forms (EUROSIF 2012). On the other hand, a lack of interest by retail investors can hardly be overlooked, as they have not kept up with the fast growing SRI institutional market. This is indicative of the need to invest in a clear communication of SRI benefits with retail investors, emphasizing their gains so that these investors can see value in SRI and consider such elements in their decision making, as institutional investors now do.

Our of all U.S. asset managers who incorporate ESG in their decisions, 72% mention their customers' demands and their own values as the main reason for doing so.

If on the one hand, the supply side is leading the way by offering assets, there is additional action on the demand side, namely the companies. The latest report issued by MIT Sloan Management Review (HAANAES et al, 2012) shows the results of a survey conducted with over 4,000 executives in 113 countries. Out of that group, 70% say they have permanently adopted sustainability as their business strategy.

Two thirds of respondents say that sustainability is necessary to remain competitive in today's market, a rate that stood at 55% in 2010; and 41 % reported their customers' demand for sustainable products and services as the key driver for such companies to change their stance.

Another noteworthy factor is an increasing demand for disclosure by institutional investors regarding corporate performance in sustainability issues. Not to mention a greater demand for investments with that focus, whether through traditional vehicles or private equity and venture capital funds.

Contrary to the hypothesis that companies only invest in sustainability whenever they have surplus funds, the MIT report shows that investments in this area have grown despite the economic crisis period. Furthermore, approximately one third of respondents say that sustainable practices are contributing to their company's profitability. Today, companies leading the growth in sustainable investment are located in Asia, South America and Africa.

The report concludes by saying that SRI seems to have reached a tilting point among companies which, aside from acknowledging the need for sustainable practices, are also reaping the associated financial benefits. While this process is commonly seen in various sectors, it is led by natural resource-intense businesses, such as those in the energy, commodities, end-consumer product, chemical, and automotive industries.

One of the reasons reportedly accountable for the successful strategy of such companies is the uncertainty of the global regulatory environment, where companies with foresight can benefit from their good reputation with governments and civil society organizations. Among other positive factors, 25% of respondents mention greater product and service innovation as a major benefit of sustainable practices, whereas in 2010 that rate was 16%. As far as process and business model innovation is concerned, the statistics were 22% in 2012 against 15% in 2010.

The Nike and Kimberly-Clark cases mentioned in the report are emblematic insofar as those companies were the target of strong criticism by public opinion due to their social and environmental performance – Nike, for human rights violations in its production process, and Kimberly-Clark for cutting down ancient arctic forests, which badly tarnished their image. Both companies now use sustainability for the sake of their reputation, financial results and innovation, and their outlook has changed dramatically. In 2010, Nike was elected one of the world's most ethical companies by the Ethisphere

Institute, and Kimberly-Clark remained a leader in the personal hygiene products category on the Down Jones Sustainability Index from 2005 to 2009.

The SIF 2012 Study seeks to highlight some key differences observed between companies that are turning their sustainability investments into profits and those that are not. Clearly, the former have a 50% greater chance of having a CEO who is keen on sustainability; they are 50 % more prone to having someone in charge of this issue in each business area; 2.5 times more prone to having a top manager in charge of sustainability; twice as prone to having operating and personal goals; and twice as prone to saying that sustainability has increased collaboration among business areas both national and internationally. These companies' level of centralized sustainability decision-making may vary, but everyone reckons there is a need for combining senior leadership with integrated sustainability management.

It also became clear that companies that adopt sustainable practices just in response to regulatory risks, rather than change their processes, have failed to reap the profitability benefits resulting from such actions. This shows that the more a company delays in including sustainability in its management practices, the greater its risk of doing so for the sake of regulatory compliance alone, with no further benefits.

3. Risk and Return

In Brazil, a comparative analysis of the performance of SRI-ranking equity funds and Ibovespa performance shows that the former provided a greater accrued financial return over the last six years, including during the crisis period, as shown in the table below, according to a study conducted by Getulio Vargas Foundation (FGV) professor Ricardo Rochman and posted in the news portal of Exame business magazine.

Period ending May 31, 2012	ACCRUED RETURN (% accrued for the period)		Number of SRI Equity Funds[1]
	Sustainable Equities	IBOVESPA	
12 months	-2.39 %	-15.68 %	15
24 months	6.73 %	-13.57 %	15
36 months	30.11 %	2.43 %	14
48 months	-8.03 %	-24.94 %	12
60 months	21.95 %	4.25 %	09
72 months	65.06 %	49.17 %	09

Source: BM&FBOVESPA

Risk and return are two sides of the same coin, so return alone provides only a partial view. A complete analysis should take into account the risk of those two equity portfolios. This analysis indicates that, in addition to a greater return, SRI funds also show less volatility over the same period.

Period Ending May 31, 2012	VOLATILITY (% per annum)	
	Sustainable Equities	IBOVESPA
12 months	15.87 %	23.10 %
24 months	14.24 %	19.82 %
36 months	15.09 %	19.38 %
48 months	22.41 %	26.16 %
60 months	21.92 %	25.37 %
72 months	20.64 %	23.96 %

Source: BM&FBOVESPA

This behavior has drawn the attention of investors and analysts who are increasingly interested in how companies are incorporating ESG issues to their strategy and management.

The article published in the Exame web portal mentions the ISE as a benchmark for Brazil's SRI funds. The ISE is being used by mirror-funds (passive funds) reflecting precisely the make-up of the ISE portfolio and active funds, which use the index as a benchmark but do not follow its specific make-up.

1 The funds used for this analysis were: BB Ações ISE Jovem FIC FIA; Brad Prime FIC FIA Ind Sust Empresarial; Bradesco FIA Índice de Sust Empresarial; Bradesco FIC FIA Planeta Sustentável; Caixa FIA ISE; FIA Vot Sustentabilidade; HSBC FIA Sri; HSBC FICFI de Ações Sustentabilidade; Itaú Ações Excelência Social FICFI; Itaú Excelência Social Ações FI; Itaú Pers Ações Excelência Social FICFI; Itaú Priv. Excelência Social Ações FICFI; LM Ações Sustent Empresarial FICFI; Santander FI Ethical II Ações; Santander FICFI Ethical Ações.

Similarly to the situation in Europe and the United States, during the 2008 crisis, SRI equities in Brazil appreciated in value as compared to other shares. Still according to Exame magazine this good performance is due to an increasing demand by investors who recognize their lower risk from both an environmental, social and financial viewpoint.

4. Value Gains

4.1 Tangible gains

Several surveys show converging results that substantiate tangible gains from sustainable and responsible investment. For investors, these gains come from equity premiums, while for companies these gains come mostly from higher yield rates and greater market value. The table below summarizes a few studies that statistically illustrate financial gains from SRIs.

The study methods adopted range from simple techniques, i.e., correlation analysis, to more sophisticated methods that seek to demonstrate causation by means of linear regression and panel analysis using different control and non-parametric ranking variables in order to correct the self-selection bias problem.

Quantifications through financial and social and environmental ratios also vary. Examples of the financial ratios used are: Tobin's Q, Return on Equity, Return on Assets, Return on Investment, Return on Sales, and Return on Investment Portfolio (in the case of investor gains). As for socio-environmental indicators, the analysis is performed using a simple comparison between companies listed on the ISE index and those that are not; or yet, by using measurements provided in sustainability reports disclosed by companies or independent entities.

STUDY	GOAL	METHOD	RESULTS
What is the Value of Corporate Social Responsibility? An answer from Brazilian sustainability index *Author: José Luiz Rossi* Publication: *Prêmio Banrisul de Finanças Corporativas e Banking, 2009* [Banrisul Corporate Finance and Banking Award, 2009]	Identify the impact of Social and Environmental Responsibility on a company's financial value, focused on the ISE index	• Listed companies, except for financial institutions, from 2005 to 2007 • Financial indicator: Tobin's Q (Economatics). • Socio-environmental indicator: the company's presence on the ISE • Impact analysis of Corporate Social Responsibility (CSR) policies on the company's Tobin's Q value. Tobin's Q is a measurement that seeks to reconcile market value to book value by comparing the market value of fixed assets to the replacement value (book value) of the same assets. • Linear regression (pooled MQO) and panel analysis methods; and use of a non-parametric ranking to eliminate the selection bias problem. • Use of sundry control variables: derivatives (hedge funds for risk control), company size, financial market access (distribution of dividends), leverage, profitability, investment opportunities, geographic and industry diversification, mean Tobin's Q for the industry, and overall economic and political factors.	Compared to companies listed on other indices, companies on the ISE portfolio **have a higher Tobin's Q**, are larger companies, use more derivatives in their risk management, are less leveraged, pay higher dividends, and are more profitable. The pooled MQO and panel models demonstrated the **existence of a statistically significant causation between ISE participation and financial performance**. The model indicated that companies adopting such policy have **10% to 19% higher market value** than other companies. Analysis through probability ranking eliminates the selection bias problem and **reaffirms a positive causation**.
The Corporate Social Performance – Financial Performance Link *Authors: S. Waddock and S. B. Graves* Publication: *Strategic Management Journal*, 1997	Measure the impact of financial performance on social performance and vice versa.	• Statistical analysis by linear regression. • Social indicators: relationship with local community, employees and the environment, product features, treatment of minorities (obtained through the KLD's social rating). • Financial indicators: return on assets, return on equity, and return on sales. • Control variables: size, company's risk tolerance, line of business.	The ratio was positive and significant both for the hypothesis that **financial performance impacts social and environmental performance and for the inverse hypothesis**. It demonstrates that **available funds have a positive impact on social and environmental performance**. It also demonstrates that **good social and environmental performance has a positive impact on future financial performance**.
A Strategic Posture Towards Corporate Social Responsibility *Authors: E. H. Bowman and M. Haire* Publication: *California Management Review*, 1975	Analyze the impact of the companies' Social Responsibility in on their financial performance, considering companies in the food processing industry.	• Analysis of content of the companies' social reports. • Social indicator: number of actions developed by the company, i.e., community outreach activities, social, environmental, and corporate citizenship actions. • Financial indicator: return on equity.	**Positive ratio** between the number of social actions and financial performance.

STUDY	GOAL	METHOD	RESULTS
Corporate Sustainability and Return for Shareholders: an ISE study *Authors: Edson Aparecido Dias and Lucas Ayres Barros* Publication: ENANPAD, 2008	Investigate whether a company's entry on the ISE portfolio adds value to shareholders.	• Compares the returns of companies on the 2005 ISE portfolio to the returns of companies in a control group in the same sector. • Quantitative analysis and statistical procedures. • Event study methodology considering windows of up to 15 days before and 120 days after ISE portfolio disclosure.	Companies that integrate the ISE Portfolio have **abnormal and statistically significant returns** when compared to peer companies within the same economic sector. On the event window of 2 days before and 2 days after ISE portfolio announcement, portfolio companies have an abnormal, accrued return of 1.9% over companies within the same sector with a statistically high significance (less than 1%; p-value of 0.000 %). In the event window from the day of announcement to one day later, the abnormal, accrued return is 0.78% with a significance of less than 5%.
The Corporate Social-Financial Performance Relationship: a typology and analysis *Authors: L. E Preston and D. P O'Bannon* Publication: *Business and Society, 1997*	Analyze the relationship between the social performance and financial indicators of 67 large U.S. companies.	• Calculation of correlation coefficients between socio-environmental and financial indicators over 11 years. • The coefficient is calculated for two ratios: within the same time period and, subsequently, with lag times in order to define the direction of the causal link. • Social and environmental indicators: responsibility to the community and the environment, people retention, and quality of products and services (*Fortune Reputation Survey*). • Financial indicators: return on assets, return on equity, return on investment.	**Positive and statistically significant correlation** between financial and socio-environmental performance. **Social and environmental indicators have a positive impact on financial indicato**rs, and vice versa, whether in the same year or with lag time.

Three different approaches were identified that sought to quantify the gains derived from company participation in voluntary sustainability initiatives, such as ISE participation.

One approach tests the relationship between the company's financial performance and its social and environmental performance. In other words, financial indicators are used, i.e., return on equity and return on assets, to verify their impact on social and environmental indicators, such as people retention or quality of products and services, or vice versa. Studies along this approach are not ISE-focused.

Another study compares the market value of a given group of companies that comprise the ISE portfolio with a group of similar companies that do not. The conclusion reached by the study is that ISE portfolio companies have a market value 10% to 19% greater than other companies.

Finally, a third approach seeks to observe any abnormal variations in market equities due to specific events. One study checked on the abnormal accrued results for companies on the ISE portfolio within a two-day time window before or after the portfolio announcement. This abnormal return prior to the announcement could be due to the market betting on a company's permanence or entry in the portfolio and, after the announcement, to a positive response from investors to indexed companies. Studies using different methodologies show financial gains for companies and investors that follow sustainability-related strategies.

Despite the favorable results highlighted herein, there is no consensus in academia regarding the tangible value generated by investments in corporate sustainability, be it for companies or their stakeholders. However, other research papers have sought to identify the intangible gains that might precede such tangible gains.

4.2 Intangible Gains

Various studies point out company traits that might call for the adoption of a more proactive strategy to participate in sustainability projects, such as the ISE. Among the factors mentioned in the available literature are:

- **Ability to innovate** and continually improve (López-Gamero, Claver-Cortés and Molina-Azorín, 2008)
- **International operations** (Bansal, 2005)
- Company size and **available resources** (Lee and Rhee, 2007; Bansal, 2005; Walls, Phan and Berrone, 2008)
- **Senior management engagement** (Lee and Rhee, 2007; Bansal, 2005; Walls, Phan and Berrone, 2008)
- **Being historically involved with environment-related issues** (Walls, Phan and Berrone, 2008; López-Gamero, Claver-Cortés and Molina-Azorín, 2008)
- **Media visibility / media attention to** the company and its sector (López-Gamero, Claver-Cortés and Molina-Azorín, 2008; Bansal, 2005)

When a company possesses these traits, there are three factors that guide its decision to join voluntary sustainability initiatives: competitiveness, legitimacy, and ethically-based environmental responsibility (its own values and principles). Companies are often motivated by more than one of these factors but, as a rule, one of them prevails over the rest (Bansal and Roth, 2000).

Presented below are the main benefits identified in the literature that are expected by companies for their participation in voluntary sustainability initiatives:

- **Competitive edge as a first mover:** Environmental regulations might encourage innovation, leading to lower costs or higher value for the company, and thereby offsetting any compliance costs (PORTER and VAN DER LINDE, 1995).

- **Reputational gains**: Previous environmental impacts that have caused a backlash as a result of environmental disasters can influence the way an organization responds to institutional pressure (DELMAS and TOFFEL, 2008). Since reputation building is a social construction, it requires dialogue and proactive transparency on the company's part.

- **Ability to influence the regulatory environment**: Kolk and Mulder (2011) emphasize that, in light of regulatory uncertainties, an organization's anticipation of regulations that may be laid down in the future can give a competitive advantage to pioneering companies.

- **Access to knowledge**: Sustainable development issues have their own uncertainties, particularly due to the ever-changing nature of expectations and the complexity and difficulty of resolving an issue within this context. Accordingly, companies usually follow the pack in their sector and, by doing so, they are less likely to be legally sanctioned on account of having lawfully adopted practices shared with most companies (BANSAL, 2005). King and Lenox (2004) point out that voluntary sustainability initiatives generally involve knowledge being shared among industry members, thus enabling them to gain knowledge about more effective practices, codes and systems for managing environment-related issues, i.e., a positive cooperative effort can be observed.

In addition to the aforementioned benefits, participation in voluntary sustainability initiatives can contribute to what Porter and Kramer (2011) call **creating shared value**, i.e., generating profits that involve a social purpose, which represents a more advanced form of capitalism, whereby a positive prosperity cycle is created both for the company and the community.

Societal needs, not just conventional economic needs, define markets. It also recognizes that social harms or weakness frequently create internal costs for firms – such as wasted energy or raw material, costly accidents, and the need for remedial training to compensate for inadequacies in education. (PORTER & KRAMER, 2011)

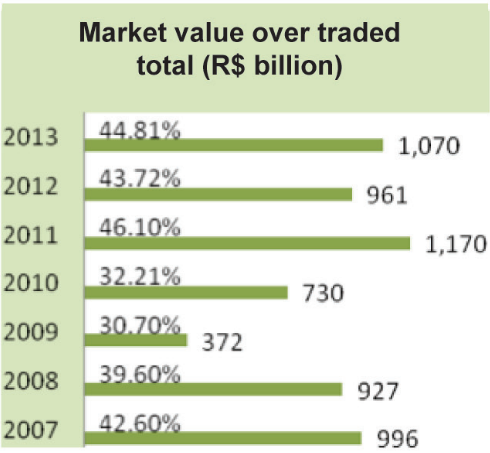
According to the BM&FBOVESPA Sustainability Guide (BM&FBOVESPA, 2010), "sustainable companies" are more capable of identifying new business opportunities, anticipating legal and social pressures, and lowering production costs thanks to decreased waste and savings , increased talent attraction and retention, easier access to capital, less risk exposure, consumer loyalty, and better internal alignment with adopted practices and policies.

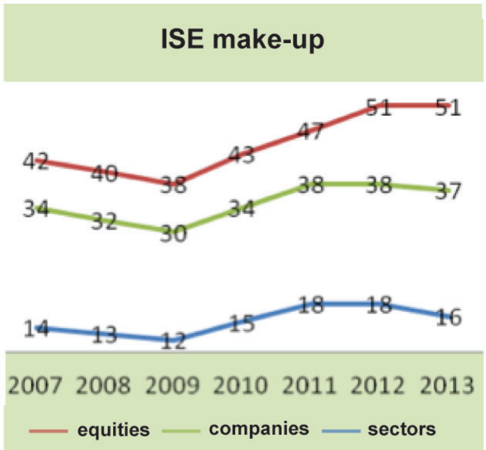
5. SRI in Brazil and the ISE

The history of sustainability indices in stock exchanges began when the Dow Jones Sustainability Index (DJSI) was created in 1999 at the New York Stock Exchange. The second index to be created was the FTSE4Good at the London Stock Exchange, and the third index, created in 2003, was the JSE, in Johannesburg, South Africa. The ISE project was originally funded by the International Finance Corporation (IFC) – the World Bank's private arm – and its methodological design was under the responsibility of the Center for Sustainability Studies of the Getulio Vargas Foundation (GVces). Created in 2005, the ISE is the world's fourth sustainability index.

The ISE follows a positive screening premise, i.e., there is no sector restriction, such as in the case of other sustainability indices, like the FTSE4Good, which automatically excludes certain sectors, such as the gun and tobacco industries.

To join the ISE, a company must first meet a liquidity condition as the issuer of one of the 200 most liquid stocks listed on BM&FBOVESPA. This is a basic criterion for funds and investors to be able to replicate the ISE index and trade this company's stock. The ISE is comprised of up to 40 such companies and its portfolio is effective from January to December of each year.





Source: BM&FBOVESPA e GVces

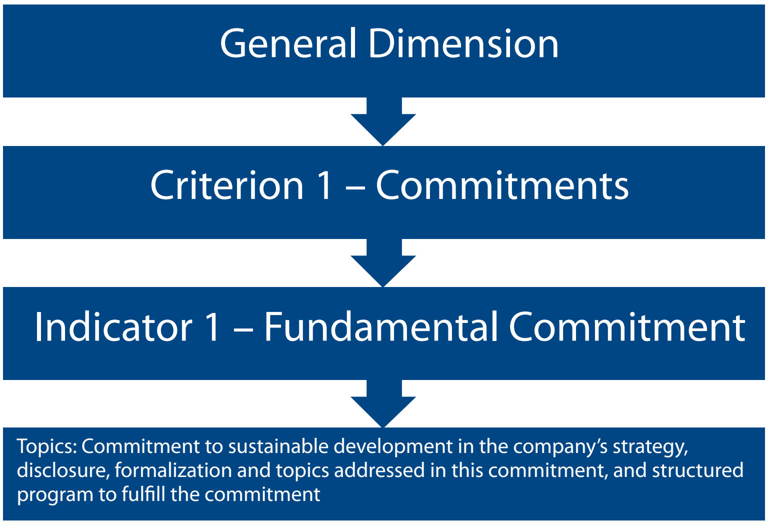
5.1 Company selection process

The ISE methodology developed by the FGV Center for Sustainability Studies (GVces) is based on company performance, a basic questionnaire, and an assessment of documents submitted to substantiate the questionnaire answers.

The questionnaire is revised every year through a participative process with the ISE's main stakeholders in workshops, online public inquiries, and public hearings.

5.2 ISE questionnaire and methodology

The ISE questionnaire is structured into dimensions, criteria and indicators. The questions are currently grouped into seven dimensions, about 30 criteria and 70 indicators, for a total of approximately 180 questions to be answered by companies. The figure below illustrates that structure.



The seven dimensions evaluate different sustainability aspects:

- **General Dimension:** Commitments to sustainable development; alignment with good sustainability practices, such as compensation pegged to the company's social and environmental performance and the adoption of a plan that provides a correlation between assumed risks, compensation actually paid, and company's results; transparency of corporate information; anti-corruption policies and practices.

- **Nature of Product Dimension**: Personal and overall impacts of products and services provided by the company, adoption of the precautionary principle, and making information available to consumers.

- **Corporate Governance Dimension**: Relationship between partners, Board of Directors' structure and management, audits and oversight, practices relating to conduct and conflict of interests.

- **Economic and Financial, Environmental and Social Dimensions**: Corporate policies, management, performance, and statutory compliance. The Environmental Dimension has different questionnaires for each group of economic sectors, considering the specifics of each sector.

- **Climate Change Dimension**: Corporate policy, management, performance and level of information disclosure on the topic.

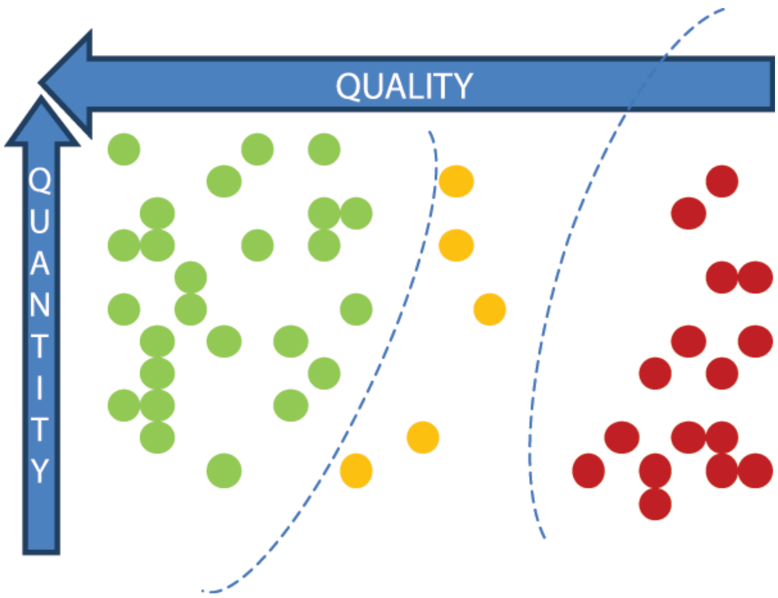
General Dimension	Nature of Product	Corporate Governance	Economic and Financial	Social	Environmental	Climate Change
Commitments	Personal Impacts	Ownership	Policy	Policy	Policy	Policy
Alignment	Overall Impacts	Board of Directors	Management	Management	Management	Management
Transparency	Precautionary Principle	Audits and Oversight	Performance	Performance	Performance	Performance
Corruption	Consumer Information	Conduct and Conflict of Interests	Compliance	Compliance	Compliance	Reporting

The methodology assigns the same weight (100) to each one of the seven dimensions in the questionnaire. The weight of these criteria is defined by how relevant the topic is in the current context of corporate management and societal demands. The weight of such criteria is available for consultation on the ISE website (www.isebvmf.com.br).

Companies are assessed within the scope of the entire work, i.e., they must show satisfactory performance in every dimension of the questionnaire and submit documents that confirm some questionnaire answers chosen on a sample basis. Therefore, the assessment method combines:

- **Quantitative analysis**: Score achieved by the company based on its questionnaire answers; and
- **Qualitative analysis**: Evaluation of the quality of the document submitted to confirm the questionnaire answers.

Chart: CISE's assessment and decision on quantity x quality technical analysis.



5.3 Funds referenced in the ISE

One of the ISE's main goals is to increase the volume of funds invested in and products pegged to the index to make it an investment benchmark. There are currently eight SRI funds in Brazil, seven of which were launched after the ISE was created.

The total invested in SRI funds in Brazil already exceeds R$800 million. After the ISE was created, there was a 68% growth in net worth.

Fund	Net Worth	Manager
BB TOP ACOES INDICE SUSTENTAB EMPRES FIA	R$ 20,846,100.57	BB
BRADESCO FIA INDICE DE SUST EMPRESARIAL	R$ 61,954,053.84	BRADESCO
HSBC FICFI DE ACOES SUSTENTABILIDADE	R$ 38,901,869.09	HSBC
CAIXA FI ACOES ISE	R$ 6,485,162.81	CAIXA
FIA VOT SUSTENTABILIDADE	R$ 21,027,597.20	VOTORANTIM ASSET
SANTANDER FI ETHICAL II ACOES	R$ 326,812,763.29	SANTANDER
ITAU EXCELENCIA SOCIAL ACOES FI	R$ 252,771,784.98	ITAU
LM MASTER SUSTENT EMPRESARIAL FIA	R$ 72,573,973.24	LEGG MASON WESTERN ASSET
TOTAL	**R$ 801,373,305.02**	

Source: Brazilian Association of Financial and Capital Markets (Anbima), November 2012

5.4 ISE's ETF

In addition to referenced funds, investments can be made in Exchange Traded Funds (ETFs) tied to the ISE. The ETF is an investment fund that seeks to replicate the performance of stock market indices and allows investors to hold equity interests in different companies and market segments, without the need to manage and follow up on them individually.

The ISE's ETF has accrued a net worth of R$10,852,094.69 (as of November 2012) since it was first launched in October 2011. The main ISE ETF investors are Pension Funds:

Investor Type	Interest Held
Institutional Investors	0.11 %
Individuals	0.17 %
Investment Funds	99.72 %

Source: Itaú

6. ISE for Pension Funds

According to Ricardo Rochman, FGV professor in São Paulo, the ISE is used by many fund managers as a means to identify "sustainable actions" to be included in their portfolios (YAZBEK & WILTGEN, 2012). Pension Funds therefore play a key role in encouraging and boosting sustainable and responsible investments in Brazil.

A survey conducted by the Brazilian Association of Private Pension Funds (ABRAPP), partnering with the PRI (Principles for Responsible Investment) gathered data on 12 Brazilian Pension Funds which jointly add up to more than R$260 billion in assets under management or 45 % of Pension Funds' total estimated investments in Brazil (ABRAPP, 2012). The aim of this study is to understand how the ISE can help investment analysis and what kind of value the analysis can add for investors, companies and society.

6.1 The importance of disclosure

According to the ABRAPP/PRI survey, the social and environmental information considered by companies in their investment decision-making process relates to product nature, transparency, corporate governance, the environment, stakeholder relations, risk management, indicators used, and social programs undertaken by the company.

The main public disclosures used by analysts today are reports published on the company's website, reports issued by the Brazilian Securities & Exchange Commission (CVM), sustainability reports, Carbon Disclosure Project (CDP) questionnaire, the Ethos Institute and Global Reporting Initiative (GRI) indicators, IBASE's Social Balance, and International Labor Organization (ILO) guidelines.

The survey also showed that the depth of social and environmental data required from companies by the Funds is greater than that required in the ISE questionnaire in only 25% of the companies surveyed. Therefore, it can be concluded that the portfolio companies are more prepared to respond to investors' demands, and that, on the other hand, Funds can raise the bar on their requirements for social and environmental practices adopted by companies, which can lower their investment risks and increase their sustainable practices.

In 2011, the ISE started a transparency promotion effort by including in its questionnaire a question about an authorization to disclose the company's answers on the ISE website (www.isebvmf.com.br). In the 2012/2013 ISE portfolio, 14 companies authorized disclosure of such information.

According to the ABRAPP/PRI survey, 75% of companies have used or are planning to use in their investment analyses the questionnaire answered by companies available on the ISE website in up 12 months. This will further enhance the importance of disclosure in the investors' analysis and decision-making process.

The Banco do Brasil Employee Pension Fund (PREVI) says that it uses the ISE as a positive screening criterion for selecting its equity products. According to the Vale do Rio Doce Social Security Foundation (Valia), "the ISE encourages companies to increase the transparency of their data. Access to information contributes to investors' decision-making."

6.2 ISE knowledge by managers and analysts

Although managers and analysts deem relevant for each company to disclose its complete questionnaire, the ABRAPP/PRI survey found that the level of knowledge about the ISE questionnaire contents is still quite low:

- 33% respondents have not had a chance to become acquainted with the questionnaire;
- 50% are familiar with its structure and the topics addressed;
- 17% say they have more in-depth knowledge of the ISE questionnaire, including not only its structure and the topics addressed, but also a full reading of all the issues.

These results indicate that the practices mapped out by the ISE need to be reinforced among managers and analysts, showing how the analyses they perform can be integrated into the data available in the questionnaire.

A proposal would be to develop, in a partnership between BM&FBOVESPA and GVces, a series of meetings, events and workshops targeted at that audience and intended to train them on how to use the questionnaire as a tool in their investment analysis.

6.3 The ISE's role in investment decision-making

According to the ABRAPP/PRI survey, the ISE's main contributions to investors and companies are:

- Serve as a market benchmark;
- Be a source of detailed and additional information for asset selection;
- Serve as a standard guideline for evaluating company performance insofar as socially and environmentally responsible investment is concerned;
- Encourage companies to increase the disclosure of their information;
- Add value to companies within the ISE portfolio, given that ISE profitability has proven to be higher than or equivalent to Ibovespa's in its seven-year history;
- Incorporate sustainability on Brazilian companies' agendas.

To Valia, the ISE index serves as a benchmark for its annual equity portfolio ranking. Furthermore, companies within the index portfolio are exempted from the institution's evaluation of their social and environmental risks.

To CargillPrev Complementary Pension Fund, the ISE goes beyond investors' concerns to also reflect market concerns, as the index seeks to ensure the perpetuity of the business and the working and living conditions of individuals.

The cultural change brought about by the ISE was also pointed out as major contribution, since "every time profitability becomes evident, an increasingly large number of investors will pay attention to the process, and this has a multiplying effect," according to the Infraero Social Security Institute (Infraprev). "The ISE helps institutions incorporate into their investment policies a greater stake in companies within the portfolio and include positive and negative selection criteria geared to sound sustainable practices in their investment analysis," remarks Infraprev.

Long-term investment is an ongoing concern among institutional investors. To Petrobras Social Security Foundation (Petros), "ESG aspects are extremely relevant in long-term investments where the focus is on corporate sustainability." PREVI remarks that "investors seem to be underestimating the impact of sustainability on Brazilian companies, particularly on those more directly exposed to foreign competition."

Real Grandeza Social Security and Assistance Foundation says that leveraging sustainability-oriented assets "leads to a greater capacity to obtain the long-term financial returns required to warrant the actuarial commitments made through a strategy aimed at generating results responsibly and in line with its business profile." In that regard, the ISE plays a key role in facilitating access to "detailed information capable of supplementing our asset selection and serving as a standard guideline for evaluating company performance insofar as social and environmental investment is concerned," says Real Grandeza.

Below is some feedback from the respondents in the survey on the importance of SRI:

"PREVI believes that sustainability addresses the company's ability to thrive in a competitive and ever-changing business environment by anticipating trends and acting proactively to seize the opportunities arising from major economic, environmental and social changes. Our institution seeks to invest in companies that address such factors through innovation, quality and productivity, as they tend to create more long-term value." – Banco do Brasil Employee Pension Fund (PREVI).

"By incorporating sustainability-oriented assets into their employee benefit plan, institutional investors consistently enhance their ability to obtain the long-term financial results required to warrant actuarial commitments made through a strategy aimed at generating results responsibly and in line with their business profile." – Real Grandeza Social Security and Assistance Foundation.

"Companies within the ISE portfolio are generally exempted from assessment of social and environmental risks by our in-house analysis team." – Vale do Rio Doce Social Security Foundation (Valia).

"The ISE goes beyond investors' concerns to also reflect market concerns, as it seeks to identify companies that include social and environmental issues in their business management, and also to ensure the perpetuity of the business and the working and living conditions of individuals." – CargillPrev Complementary Pension Fund.

"This is a cultural and value issue whereby every time profitability becomes evident, an increasingly large number of investors will pay attention to the process. This has a multiplying effect." – Infraero Social Security Institute (Infraprev).

"ESG aspects are extremely relevant in long-term investments where the focus is on corporate sustainability." – Petrobras Social Security Foundation (Petros).

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