**Sustainability reporting, financial analysis, and possible pricing effects on financial securities**

Over the past ten years, sustainability has received increasing focus in financial markets. European authorities have a stated goal that a larger share of private capital should be channeled towards sustainable companies and projects.

To achieve this, the EU has introduced several laws aimed at reporting sustainability effects by companies, both listed and large private. The aim is for such reporting to put financial market participants in a better position to price this information into risk and return assessments, and it is expected that this will contribute to private capital increasingly finding its way to companies and activities that contribute to environmental and sustainability goals.

To speed up the process of channeling private capital towards sustainable businesses and activities, the EU has also introduced a law requiring financial advisers and portfolio managers to explicitly ask investor clients whether they have this type of goal with their investments, and if so, what proportion of their portfolio should be allocated to each target.

To answer such questions, investors must be provided with information of sufficient clarity and depth to ensure that the decision is rational and of good quality. This paper aims to clarify important factors in this context.

**Securities pricing and the effect of sustainability elements on expected returns**

To understand risk and return in the securities market, it is uncontroversial to assume that financial markets are characterized by high competition. Investors and other stakeholders try to acquire and analyze information that could give them an economic advantage. An investor will consider the expected return that could be obtained by holding a broad index portfolio and set a required rate of return for each individual company or project relative to this.  For markets to function as efficiently as possible, it is important that relevant information about companies' future profitability and risk in their operations is available.

Over many decades, accounting standards globally have evolved, ensuring that financial information from firms is relatively homogeneous and thereby comparable. There are different requirements for which accounting standard an enterprise should use, but regardless of which standard applies, the methods used to report accounting figures are specified, and an external user of accounting data should be able to trust that an accounting report gives a correct picture of the company's historical profitability and financial position.

These accounting reports form the basis for the future assessments made by financial market participants such as analysts and investors when estimating future profitability and risk, and which thereby form the basis for the relevant pricing of the security.

In addition to accounting information, an investor will also base her decision on other, non-financial information. Such non-financial information is generally far less quantifiable and standardized, and is thus inherently less objective.

Sustainability information from a company will be non-financial information that comes in addition to financial reporting. With higher requirements for the scope and frequency of reporting of sustainability information by the EU and other authorities, the aim is that when this information becomes available, rational financial market participants will incorporate this into their assessments of return potential and risk.

Sustainability reporting from the business sector has historically been poorly standardized and formal, despite the fact that many companies have used reporting guides from international organizations. With new legislation, such as the European taxonomy, some companies will now report using a more stringent template, and in some areas more quantitative. Nevertheless, much of this information will remain qualitative and to some extent subjective.

In any case, market participants such as financial analysts and investors will gradually incorporate this information into their assessments. For example, rational operators will make decisions that some securities may appear mispriced because sustainability elements around the company are undervalued. A key issue on the part of the authorities is 'stranded assets ‘, which describes a situation where a company's assets generate sufficient cash flow today to justify their balance sheet value, while in the future they may be worthless due to sustainability changes.

The important thing is that sustainability reporting provides more information about the business of the companies. The outcome of this incorporation of sustainability information is thus transparent in relation to the pricing of the security and thereby return potential and unsystematic risk. A security that is priced highly, but where the company seems well positioned on sustainability, is not necessarily an investment with a good, expected return. Conversely, a business in a sector with a high expected need for restructuring is not necessarily an investment with weak return opportunities.

Better and more standardized sustainability information from companies will improve financial markets' ability to assess future profitability and risk, but it is not given how this will affect the pricing of individual financial instruments and thereby the return potential. Investors must decide on this based on the available information.

Sustainability reporting is thus not included as a separate assessment of an investment, but rather as an integral part of the information pool that ensures the right pricing of the security in the market over time.

**Reporting from the companies**

There is already significant information that companies report as non-financial information and 'sustainability reports' have become commonplace. Several agencies and consultants regularly assess the quality of the actual reporting. These assessments are based mainly on three criteria:

1. The extent to which the company reports in accordance with recognized voluntary international standards
2. Whether the company quantifies climate emissions
3. Whether the company has goals for improvement and whether progress is reported

These assessments of the quality of reporting do not say anything about how 'environmentally friendly' or sustainable the company is. This concerns only the quality of the report.

Other consultants and agencies go further and make a concrete assessment of the sustainability of the company. These use the information reported by enterprises together with their own models and expertise and combine this into a score, for example on 'greenness'. It is important to assume that this type of assessment, in the same way as other analyses, depends on occasionally subjective data from the companies and the consultant's own assessments. Therefore, it is to be expected that there may be differences in perceptions of how sustainable the same company is between the different consultants. This is also what has been observed in studies conducted in this area; the same company can get very different 'greenness scores' from different consultants.

This is a situation that can be expected to persist in the future. Investors cannot therefore indiscriminately base their assessment on a score from an individual consultant.

The safest thing for an investor is to make independent assessments of non-financial information as an integral part of the analysis, as described in the previous section.

**Channeling private capital towards sustainable businesses**

It is a stated goal of politicians in the EU that more private capital should be channeled towards sustainable investments. Financial advisers and portfolio managers are thereby obliged to ask their investor clients whether they have sustainability preferences. In the event of a positive response, they will also ask a series of detailed questions about the type of sustainability preferences investors have as well as whether there are targets for allocations of the total portfolio to be invested in line with the different preferences.

Given the description above of the unquantifiable quality of the data on which this type of assessment is based, and the uncertainty of how this categorization affects return and risk assessments, we encourage investors to make independent assessments of this type of information for the individual investment and to be cautious about investing based on simple categorization.

**Conclusion**

Pricing securities is complicated. Return and risk go together. Sustainability information is valuable input in financial analyses and over time the companies that are best adapted to future requirements and customer demand provide the best return to investors. In this sense, sustainability elements are an integral part of financial analysis.

Allocation of investments in a securities portfolio based on sustainability parameters can work, but then only as a starting point. All individual investments must be carefully evaluated based on risk and return potential and with a realistic view of the direction causal relationships are heading.