AN INTEGRAL APPROACH TO ESG INVESTING

International Alpha Team. Third Quarter 2018

BAILLIE GIFFORD

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INTERNATIONAL ALPHA TEAM

While we do not promote our strategy as either an Environmental, Social and Governance (ESG) portfolio or one that is run on explicitly green or socially responsible principles, we believe that consideration of these factors should be integral to the investment process of any genuine long-term investor regardless. For this reason, approaching ESG by applying a screen to filter out 'undesirable' companies, although increasingly common, especially for those investing on a passive basis, is insufficient. Those with an interest in how companies operate and the impact they have should take full advantage of the access long-term active investors have to companies' management and, where appropriate, use that influence to engage with them and bring about change for the benefit of all stakeholders.

LONG-TERM AND ESG INVESTING ARE SYNONYMOUS

Financially-relevant ESG considerations should be integral to the investment process of any genuine long-term investor. This would include assessing the sustainability of a company's business model and ascertaining what the management (or the owner's) attitudes are towards making long-term returns to shareholders. These are not something that can be easily ticked off using an inflexible checklist. Nor is there some hitherto undiscovered or ignored dataset that simply needs to be 'integrated' into the myopic investment manager's outlook. ESG should be incorporated into the research on the investment case in the same way as all other fundamental factors that could affect a company's future growth prospects.

We would summarise the influence of ESG on International Alpha's decision making in the following way:

OUR CLIENTS ARE LONG-TERM OWNERS OF BUSINESSES, NOT SHORT-TERM RENTERS

At Baillie Gifford, we are bottom-up, active, investors with a long-term (5–10 year) investment horizon. Being a private partnership, we are able to take a long-term approach to all that we do. This allows us to exploit persistent stock market inefficiencies, which arise mainly as a result of the stock market's bias towards periods of less than a year. We aim to invest in well-managed growth companies that have a sustainable competitive advantage and attractive financial characteristics. On behalf of our clients, we are long-term owners of businesses, rather than short-term renters of shares. An integral part of our analysis both prior to purchase, and on an ongoing basis, is assessing whether society will support or at the very least tolerate the business model over the long term, and whether management will act as good stewards of shareholders' capital.

BUSINESS MODEL SUSTAINABILITY: A BROAD RANGE OF ENVIRONMENTAL AND SOCIAL FACTORS ARE CONSIDERED

While we do not screen for, or exclude, certain types of business, a broad range of environmental and social factors are considered where these are material to the long-term sustainability of a company. Factors that can impact the industry backdrop for a business include globalisation, climate change, population trends and country-specific policy developments (regulations, labour and tax rules). Attitudes to internal and external stakeholders (suppliers, customers, employees and regulators), supply chain resilience and corporate culture can also be considered as part of the research process. The materiality of environmental and social factors varies, but in broad terms they matter, because they have the potential to impact a company's reputation, brand, sustainable growth opportunities and financial returns.

Although we don't prioritise sustainability over and above investment performance, our portfolio holds a number of companies whose long-term competitive advantage is linked to environmental/energy efficiency benefits, including: manufacturing industrial enzymes; more energy efficient jet and vehicle engines; building insulation products which reduce heat loss; more energy efficient lighting and products that help reduce home energy consumption.

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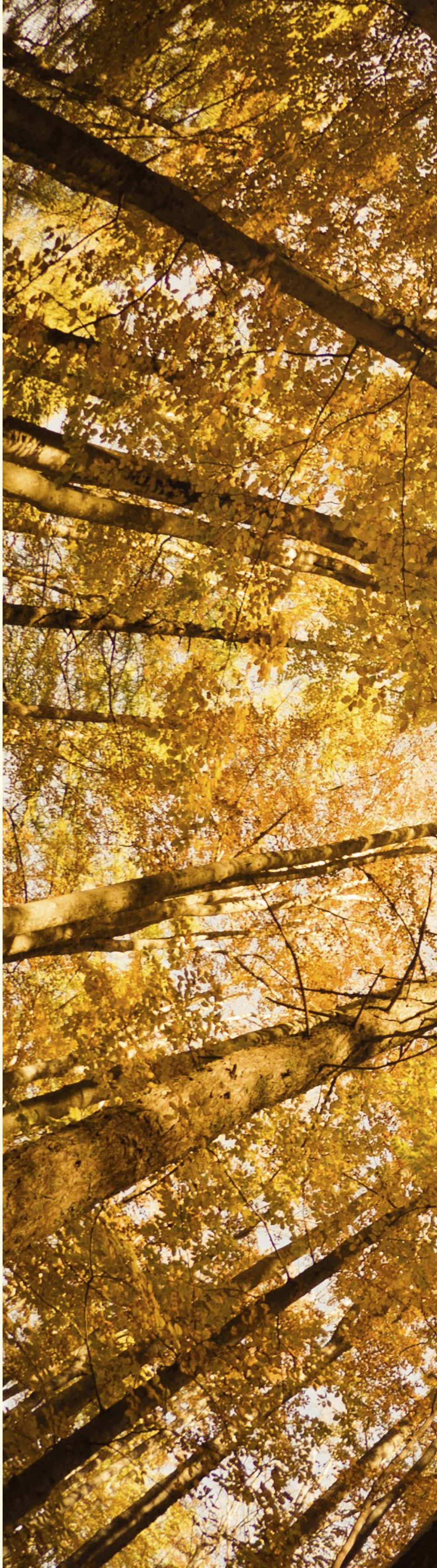
WILL MANAGEMENT ACT AS GOOD STEWARDS OF SHAREHOLDERS' CAPITAL OVER THE LONG TERM?

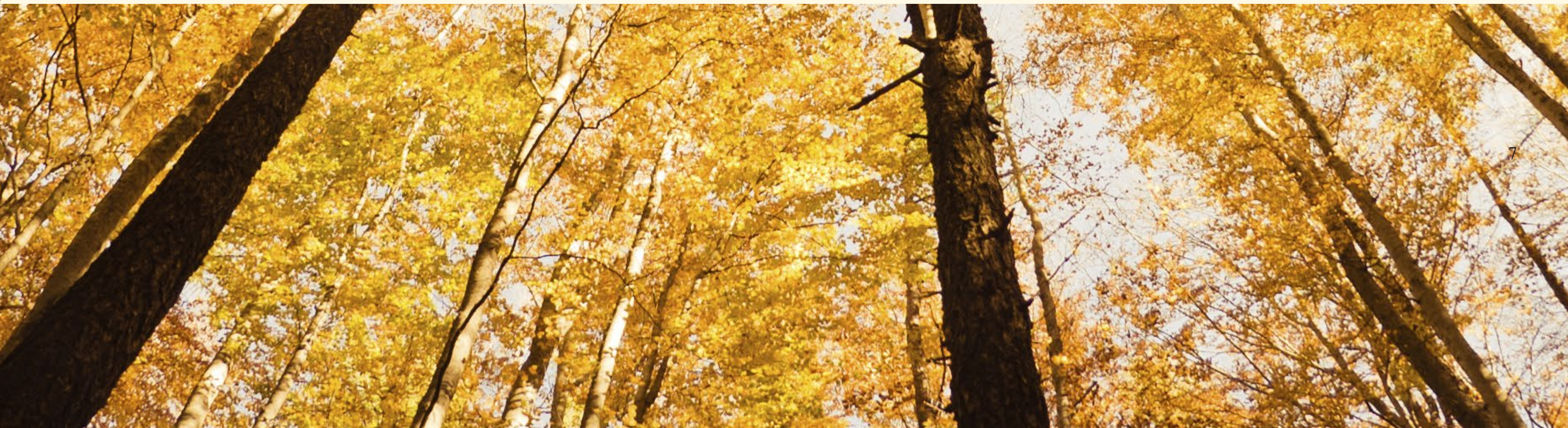
Our assessment of company management includes its alignment with shareholders. Many of our holdings enjoy the benefits of long-term stable shareholders and are managed more like 'private-public' companies, and there are a number of family/founder companies (where management have significant stakes in the business) in our portfolio. We also consider: appropriate remuneration and incentive structures, capital allocation track record and future plans, prudent financial management, long-term strategy and Board composition, skills and experience. Governance therefore plays a central and critical role in the investment decisions we make for our clients, both prior to purchase, and in terms of ongoing monitoring and engagement.



WE TAKE A LONG-TERM, ACTIVE APPROACH TO ONGOING ESG ENGAGEMENT

We take an active approach to share ownership rights and responsibilities on behalf of our clients. We engage with companies on ESG issues that we think may prove material to the long-term sustainability of a company's business. To facilitate this process, a senior investment manager is appointed as the primary contact for our larger holdings, and is responsible for matters such as governance (in conjunction with our Governance and Sustainability team), meetings and company access. This increases the clarity and quality of our relationship with investee companies and their management. Our reputation as thoughtful, long-term investors sometimes gives us an increased level of access to and engagement with companies, an advantage that applies to some stocks in our portfolio. We exercise patience in our approach to engagement, seeking to achieve positive outcomes over time.

While this approach is not new for us, the broad topic of ESG is of increasing interest to our clients and the wider market. There are a number of reasons for this. Concerns surrounding climate change, sustainability, diversity, employee relations, human rights, wealth inequality and executive pay are all significant issues which are quite rightly receiving increased attention in the global media. This is reinforced by a growing feeling, especially since the global financial crisis, that capitalism is 'broken'. This is understandable: the distortions resulting from quantitative easing in the form of low or negative interest rates and, possibly related to this, weak growth over the last decade has led the corporate sector to distort further the meaning of 'shareholder value.' This has led to companies prioritising delivering short-term returns to shareholders (and corporate executives) over longer-term investment in the company and stakeholders more broadly. There is a growing belief that we could and should do better.



ESG 1.0: A FLAWED APPROACH?

Unfortunately, the investment industry is all too eager to jump on the increasing interest in ESG in order to gather assets. Previous moves in this direction, such as Socially Responsible Investing (SRI), relied on a simple divestment strategy that resulted in the desired controversy-free portfolios. However this strategy has typically led to lower returns for the client, and has also not made as much of an improvement to business practices as you might think. By not owning and therefore not engaging with companies faced with ESG challenges, SRI funds exert very little direct pressure on companies to improve ESG practices and do not command enough assets to be persuasive otherwise. Despite their best efforts, the most commonly screened out 'sin stocks' of tobacco and arms have proven to be remarkably enduring.

Now the focus is shifting to 'screening in' positive behaviours. Intuitively, it feels correct that 'high sustainability' companies will also perform better over the long term. While the concept is inherently appealing, as with SRI, we need to be equally cautious to develop the right objectives, methodology and approach to this investment style. Research is appearing which justifies the positive screening approach based on early sample portfolios and backward testing of performance. For example, in a research note written in 2016 by Bank of America Merrill Lynch titled *"ESG: good companies can make good stocks"*, the writers highlight that companies screening for higher ESG scores[1] tended to lead to lower share price volatility and that by only investing in companies with above average ESG factors one would have avoided 90% of the companies that filed for bankruptcy. As much as we would like to believe it, much of this type of research is questionable. Why should investors looking for long-term returns worry about short-term volatility?[2] And isn't the relatively infrequent occurrence of bankruptcy a less material consideration when fundamental financial analysis has formed part of the initial assessment?

Whereas the research could therefore be much less conclusive than claimed, the message may be that ESG scoring has a role in the absence of fundamental investment analysis. However, we believe that a more effective approach to identifying high-quality investments is bottom-up research in which ESG is integral.

In addition to challenges with the methodology, there are also difficulties with the underlying process and data used in both positive and negative screening. The process substitutes a rigid tick-box mentality for what can be highly subjective considerations. Some areas, for example on the environmental side, are clear cut: we all know that cement production or air travel leads to the emission of large amounts of CO2. But even here there are areas to debate, and it is uncertain whether this will materially affect the investment case for all businesses in these sectors. Given the huge social and economic benefits that have been derived from air travel, surely the airline that employs the youngest, most fuel efficient fleet with exceptionally high load factors should be perceived in a more positive light?

1. Based upon the Bank of America Merrill Lynch US equity coverage over the period 2005–15 and using underlying ESG data from Thomson Reuters.

2. The 2008/09 crash and the works of Nassim Taleb (amongst others) should have taught us that real risk can't be modelled and that extended periods of low volatility are often a prelude to far greater stress.

In the Social and Governance areas things get trickier still. Is it always a negative for a public company not to have a one share one vote policy within its corporate governance? In many cases, and there are several examples in our portfolio, a founder shareholder or major stakeholder with disproportionate voting rights has facilitated an enlightened long-term approach to investment (often at the expense of short-term profit and in the long-term benefit of all shareholders) while protecting the company from short-term speculators. Other topical areas of debate might include the giant internet companies in the areas of social media, ecommerce and search. These internet giants are fantastic businesses harnessing the power of rapidly growing networks. But do they undermine society as much as they bring it great benefit? ESG is a very broad and subjective matter that cannot be easily screened with rules-based 'one size fits all' criteria.

Many screens are dependent upon the availability of information provided by the underlying companies. While increasing disclosure on ESG issues is a first step towards enabling stakeholders to apply pressure where needed, too often companies are scored more highly purely because they have included some glossy pages in an annual report. It won't surprise you that the major oil companies are among those that provide the most disclosure. In these situations, there is no substitute for bottom-up research which gets beyond potentially superficial indicators of ESG performance.

The situation is further complicated by many ESG funds' approach to voting. Investment managers are increasingly outsourcing the oversight of the governance of their underlying investments to third-party proxy advisors who are becoming increasingly influential, especially with the growing popularity of passive investing. As they work for very large numbers of clients, these proxy advisors operate according to rigid checklists and house policies. Inserting another barrier between companies and proper long-term engagement with their shareholders via an inflexible checklist does not feel like best governance practice to us.

At Baillie Gifford we believe that thoughtful voting of our clients' holdings is an integral part of the long-term investment process, and for this reason we strongly prefer to be given this responsibility by our clients. Our dedicated in-house Governance and Sustainability team oversees our voting analysis and execution in conjunction with our investment managers. Although we take account of proxy advisor information, we always undertake our own additional analysis and review the merits of proposals on a case-by-case basis rather than following restrictive checklists.

Taken together, these respective challenges do not undermine the logic of overtly-branded ESG funds, but they do sound a cautionary note about the objectives, process and data that currently sit beneath the recent rush to ESG integration.

CONCLUSION

As long-term investors we have a natural interest in assessing all longer term risks to a company's growth opportunity or competitive advantage. We also want to ensure that our clients' long-term interests are aligned with those responsible for company strategy. ESG covers an enormous array of different factors but in our view this is no different to any other investment case consideration. Being long term brings other benefits as a company's management is more likely to engage with shareholders who have been on the share register for some time, who don't blindly vote according to someone else's criteria, and who are genuinely interested in the success of the business over the next decade rather than the next quarter. Being long term, and taking each case on its merits, allows for a fiduciary form of stewardship-led capitalism that is hard to replicate via a checklist or passive investing.

CURIOUS ABOUT THE WORLD

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