Actual ESG.

Let's talk about Actual investing part two.

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BAILLIE GIFFORD | Actual Investors

Risk factors.

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Introduction

Baillie Gifford published part one of *Let's talk about Actual investing* in 2018. In this we challenged investors to refocus on the fundamental challenges and opportunities of real-world capital deployment and wealth creation. Investing is not a matter of 'aiming off an index', nor trying to outsmart other market participants. It is the act of capitalising on technological and cultural progress to find newer and better ways of producing the goods and services that society needs. Over time, a very small number of companies capture the vast bulk of the gains from such change, and if investors can successfully find them, excellent and even exponential investment returns potentially follow.

One theme we didn't dive into deeply in the first article was the benefits of engagement with the companies in which we invest, and how this activity is central to broader topics around company cultures, stakeholder capitalism and socially responsible investing. Here, we offer a more detailed discussion on a complex area at the top of many agendas, focusing on the need for thoughtful measures of system-wide progress over quantitative snapshots of individual companies.

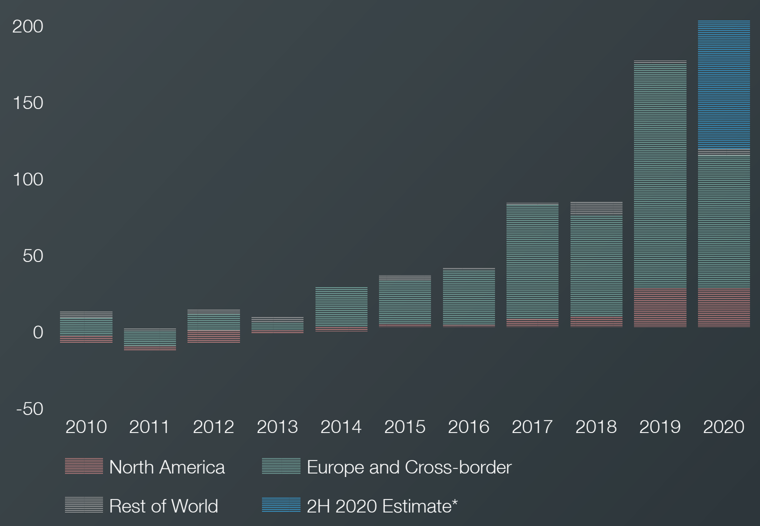
Is ESG really a thing?

Some would argue that the industry has simply – at long last – found a badge for long-term investing.

In previous comments we made passing reference to the idea that taking a very long-term approach to investing – basically ignoring stock markets most of the time – embeds the interests of society alongside the interests of investors. The essential belief is that companies that abuse the environment, treat staff poorly or damage the fabric of society will, within a relevant investment horizon, be regulated out of profitability or deserted by their customers. Ergo consideration of such factors must form an integral part of any credible long-term investment process.

What a long way we have come since 2018. Even prior to 2020's exceptional virus-induced circumstances, the idea that non-financial metrics should have a place in investment decision-making was gaining traction. Investment flows into funds badged as 'sustainable' have been growing rapidly[1].

ESG fund net flows by region (USD Billion)



Source: Broadridge Global Market Intelligence Funds.
*Data through June 2020. Second half 2020 estimated using average monthly flows during the preceding 18 months. Includes money market but excludes fund-of-funds.

1. The chart shown uses a wide definition of 'sustainable', covers all asset classes and includes both active and passive, so it's the summation of a lot of moving parts. Nevertheless, the trend is abundantly clear.

These flows reflect increasing awareness among end investors, including individuals and pension scheme members, that the unbridled pursuit of short-term profits is not likely to end well either in social or investment terms. ESG[2] as a topic is at the forefront of investors' minds, and more so as Covid-19 has demonstrated the consequences of social inequality, the desire for companies to act responsibly (particularly in times of stress), and the power of nature to upend normal life. The table below shows some of the broader topics that beneficiaries now expect investment managers to consider:

Environmental	**Social**	**Governance**
Climate change and carbon emissions	Gender and diversity policies	Board composition
Air and water pollution	Human rights	Executive compensation
Energy efficiency	Labour standards	Audit committee structure
Waste management	Employee engagement	Bribery and corruption policies
Water scarcity	Customer satisfaction	Tax
Biodiversity and deforestation	Community relations	Political contributors

2. Here we use ESG as shorthand for the broad topic of embedding Environmental, Social and Governance factors in investing. There are many other terms that have their own nuances – Stewardship (where acting as responsible owners is emphasised), Responsible Investing (probably the widest catch-all), Impact (where improving environmental and social outcomes is elevated alongside investment objectives).

In search of a grand unifying theory

Albert Einstein published his general theory of relativity in 1915, offering an explanation of how the universe works at massive scale. Ten years later Schrödinger, Heisenberg and others published their theories on how the universe works at micro scale, which started the new field of quantum physics. The problem is that how the universe works at massive scale seems to be flatly contradicted by how it works at tiny scale. Einstein spent the last 30 years of his life trying to unify these theories but to no avail. No grand unifying theory has yet been found.

We believe there's a meaningful parallel here to the challenges of ESG investing and climate change in particular, both in reconciling contradictory approaches and in its fundamental importance to our future. From the bottom-up, divesting from heavily carbon-emitting companies makes sense for climate-conscious investors. It salves the conscience, meets the immediate demands of pension scheme members or fund investors and is observable and measurable, but is a short-term answer that in practice has limited impact. Think of this as quantum theory.

From the top down, divestment makes little difference. Someone will buy the shares of the polluters and other miscreants who will continue in business unless society decides to forego such basics of civilisation as heating, aircon, car and airplane travel, construction and many other things. Regulators may or may not get involved to push the cost of damaging externalities onto companies. The companies themselves may adapt to regulation and to protect their reputation with customers. There may even be legitimate differences of opinion as to what is 'good': if making fossil-fuel based activities ever more expensive results in falling standards of living, it will be the poorest and most vulnerable who are hit hardest. On the social side, concepts such as free speech in the context of social media are not absolute: 70 per cent of the US population thinks free speech includes the right to offend others; only 15 per cent of the Japanese population thinks the same[3]. Mining cobalt is widely seen as socially and environmentally destructive, but without it the electric car revolution and the advancement of battery technology which crucially facilitates the shift to renewable energy might stall. Think of this as general relativity. Everything depends on everything else.

How do we reconcile the micro with the macro? The quantum with the universal? What we need is a 'grand unifying theory of ESG and long termism'. But let's be clear, Einstein didn't solve his problem in 30 years, and we're not going to solve ours anytime soon either. What we can do is try to inject some fundamental analysis and system-wide common sense into what is rapidly becoming an unhelpful exercise in misguided metrics. The good news is that many in the investment industry are now getting together to try to create agreed frameworks for such a theory, for example the Institutional Investors Group on Climate Change's (IIGCC) *Net Zero Investment Framework for Consultation*[4] launched earlier this year.

The fundamental challenge in holistic ESG-based investing is that nothing is outside the system. What you don't own still pollutes (or underpays workers or flouts health and safety regulations). If an oil major sells oilfields to a competitor and buys existing renewable energy assets with the proceeds, that will dramatically improve its carbon metrics. But it doesn't really change anything on the safe assumption that the buyer of the oilfields surely didn't do so just to shut them down. If the new operator can lower the environmental damage of production then there's a net environmental gain. But there could just as well be a loss.

We need to find a way to measure system-wide progress.

3. See here: https://www.ben-evans.com/benedictevans/2020/7/23/regulating-technology for a useful and interesting blog on tech regulation and other things.

4. https://www.iigcc.org/resource/net-zero-investment-framework-for-consultation/

Can governments and trade bodies help? Yes…

Financial industry regulators have joined the ranks of the environmentally and socially concerned. In the UK, the financial regulator (FCA) and the government (DWP) are making reporting on ESG issues mandatory. The EU has various initiatives in place to create common taxonomy and disclosure, and as of early September 2020 there were over 60 national financial supervisors developing guidance on the incorporation of ESG factors into investment decisions and reporting. From January 2022, large investment companies in the EU will be required to disclose the adverse impacts of their investments on the environment and society. The CFA society has started a consultation on industry-wide ESG disclosure standards and multiple other industry bodies have been created with the best of intentions – so much so that the real challenge for professional investors may be how to distil such a plethora of good intentions into something impactful.

…but not everywhere. At least not now.

Europeans are currently by far the most likely to be contemplating ESG issues, and translating this into asset allocation decisions. The US Department of Labor (DoL) is, if anything, heading in the opposite direction in its most recent guidance for defined benefit and defined contribution plans that follow DoL guidance, particularly financial advisers committed to a fiduciary standard in the US. This might best be looked at as a difference in time horizons. FCLTGlobal's[5] response to the proposed guidelines summed this up pretty well – 'What is important for the Department to recognize is that [this] economic value develops over many years, and that ERISA fiduciaries must keep the often multi-decade life of their liabilities in mind as they select the appropriate course of action.' Non-financial factors become financial if one has a long enough horizon, and they must be viewed not just for individual companies but at a system-wide level if we are to ensure progress. A savings and investment system can surely only be considered a success in the long run if quality-of-life factors don't need to be routinely sacrificed to create future incomes.

That said there are many investors in the US who are not bound by DoL guidance, and many of them are in the vanguard of socially responsible investing. Broadridge suggests the US is on the cusp of a rapid rise in ESG flows, and that if anything the DoL's guidance will lead to a more robust justification of the investment reasons for incorporating ESG factors into portfolios, and eventually a better outcome.

It's pretty clear that companies are not going to be able to indefinitely externalise the non-financial costs of poor practices (carbon emissions, social damage etc). As this realisation dawns, the good news for investors is that ESG and socially responsible investing don't need to be balanced against achieving strong investment returns: they are better thought of as an answer to our unifying theory problem. Properly done, integrating ESG factors into investment processes will actually help to create positive outcomes for this generation of savers, and the next, and the next.

5. Focusing Capital on the Long Term is a global industry body comprising asset owners, pension plan sponsors, sovereign wealth funds and investment managers which aims to foster greater long-termism in investment decision-making. Baillie Gifford is a sponsoring member. More detail here: https://www.fcltglobal.org/about/

The return of long-termism?

An oblique outcome of investors' newfound concern for environmental and social issues is that arguably the investment industry itself is being pushed into the process of becoming better investors. It has always been very difficult to coax clients off the quarterly performance cycle, with its inevitable emphasis on the latest numbers, even when we were only trying to explain that the practicalities of building a successful business are mismatched with short investor horizons and random share price volatility. Many investment firms had all but given up and resorted instead to incentivising investment professionals to give clients exactly what they wanted – index relative returns and breathless short-term commentaries. But the ESG movement has changed this conversation for the better and we could perhaps now be seeing a move back towards the long-termism from which the industry should never have departed. If clients are demanding that their managers both incorporate and report on non-financial factors, this may be a great opportunity for managers to return to a more generic form of constructive long-termism at the same time.

What has all this got to do with Actual investing (or Actual ESG)?

'What gets measured gets managed' is one of the best known business quotes around. W Edwards Deming, the admired writer on quality and business, went further. Writing in 1982, he defined the fifth of his seven deadly management diseases as 'management by use only of visible figures, with little consideration of figures that are unknown or unknowable'. This strikes us as particularly apt to how the ESG investing world appears to be panning out.

When we wrote *Let's talk about Actual investing*, we said that we don't believe that active (or more accurately, Actual) management is the same fundamental activity as passive management. The former is about the creative deployment of capital and wealth creation, the latter is a quantitative approach offering market exposure and implied reliance on efficient markets.

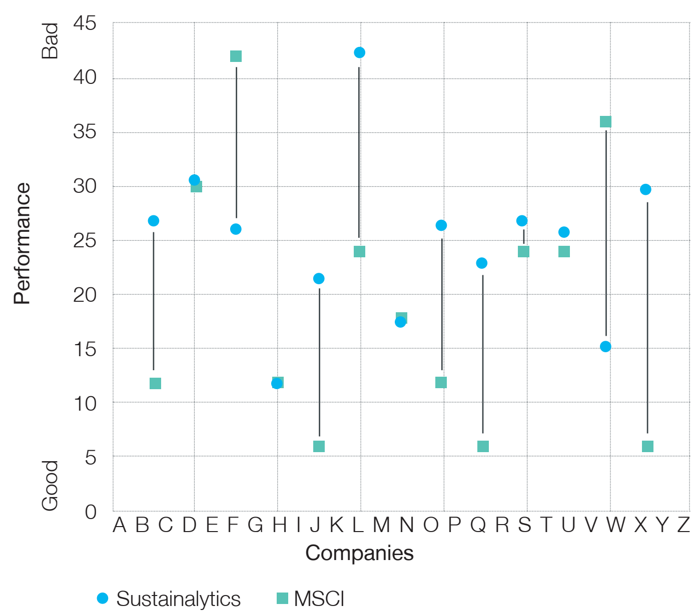
Similarly so for responsible investing. Many investors have adopted approaches to ESG, and climate-friendly investing in particular, by buying funds that passively mimic an index which is itself constructed to tilt the portfolio towards a lower carbon footprint. There's nothing intrinsically wrong with this. These are well-intentioned efforts to create lower-carbon and socially responsible portfolios, and it would be capricious to criticise too much. However, we see an analogy to the active/passive debate: using simple snapshot metrics to drive decisions is a very far cry from the ESG equivalent of wealth creation.

These metrics focus much more on the systemic risks to a portfolio than on the opportunities to drive investment returns through change. Quantitatively understanding the ESG exposures of a portfolio is no bad thing, but they should be the starting point for a discussion, not goals in themselves.

The shortcomings of quantitative approaches to ESG can be illustrated by looking at the differences in ratings of the same companies but from different data providers:

Just as wealth creation is the result of creative capital deployment, so tackling ESG issues needs system-wide understanding and integrated measures of progress in complex circumstances. Vetoing (or underweighting) companies on the basis of board composition, voting rights, carbon footprint or social impact is a clumsy tool and isn't even consistent between ESG measurers. An insightful recent paper by Berg et al[6] examined these inconsistencies across six different ESG ratings providers, concluding that

ESG scores: MSCI and Sustainalytics



Source: Baillie Gifford & Co, Sustainalytics and MSCI.
Above graph shows comparisons of Sustainalytics and MSCI ESG scores for a range of different companies.

6. *Aggregate Confusion: The Divergence of ESG Ratings*, MIT Sloan School Working Paper 5822-19

measurement divergence is the most important reason why ESG ratings diverge. In other words, different raters measure the performance of the same firm in the same category differently.

Human rights and product safety are two categories that are singled out as particularly dependent on how a ratings agency chooses to measure them. The underlying point is that ESG ratings are highly subjective, and investment firms or investors relying on them need to be aware that, on any given point, this may not square with their own interpretation of what responsible investing means.

We believe what matters is a holistic but highly specific approach, individually engaging with companies to determine how they're adapting in the real world, and encouraging them to do so. Here we differ from the recommendations of the IIGCC's paper, *Net Zero Investment Framework for Consultation*, which says:

"Engagement is a resource intensive activity so some degree of prioritisation is required. It is unrealistic to expect investors to individually engage with all companies in a portfolio".

This feels wrong to us. Engagement is indeed a "resource intensive activity" with associated costs. But it's *not* unrealistic to expect institutional investors to individually engage with the vast majority of companies in which they invest. In fact we don't see this as an ESG issue at all: it's a core part of what long-term 'Actual' investors should be doing. Of course, it's difficult for quantitative providers to offer this within their ultra low-cost business models, so they need to turn towards a mechanical rules-based approach to judging companies on their ESG merits. The challenge is that, whether it's the passive managers or the index providers, the resource intensiveness of assessing real progress in ESG factors doesn't go away.

Baillie Gifford now employs 24 dedicated and highly qualified Governance and Sustainability analysts who work alongside an investment team of over 100 people. Our governance and sustainability analysts engage directly with the companies in which we invest (or potentially invest) and assist our investment teams with ESG considerations directly within their investment decision-making process. Bear in mind that we run concentrated portfolios and own only a tiny fraction of the available universe across the world – this is the level of resource we believe is required to act as responsible investors. Importantly, we do not adopt a one-size-fits-all approach. Companies must think and behave differently depending on what stage of development they are at. The 'correct' governance model for an early-stage entrepreneurial growth company is likely to be very different from that of a mature and sizeable incumbent. The need and practicality of a company with regard to its social impact surely scales up with its number of customers and employees. Priorities are different from company to company and evolve over time. We believe that no amount of quantitative filtering can adequately capture this.

Two simple examples would be Alibaba and Tesla, both of which Baillie Gifford holds for clients. Each takes an unconventional approach to shareholders, board structures and rewards, but in both cases we welcome this, given the drive and vision of the founders. In the case of Alibaba, the firm actually states that they put the interests of customers first, employees second and shareholders third. This doesn't tick any of the conventional boxes, but we think it wholly appropriate for a firm of this type at this stage. At Tesla, corporate governance form-filling suggests it has, at least historically, been a poorly governed company by conventional standards, dominated by an idiosyncratic founder. There may be something in that – though we would argue it has changed anyway – but surely it pales into insignificance when set against the fact this might just be the single most important company in the next 20 years in terms of making a difference to climate change? And would we realistically expect a conformist box-ticker to achieve such heroics?

Learning from others

Some attempts are being made to tackle the pitfalls of the quantitative approach to ESG by the creation of ESG reporting standards for companies. We wholly support this but it's still in its early stages[7]. Our own work with Mike Berners-Lee, a leading climate change scientist, suggests that the reported data on which index providers produce carbon metrics may well understate it by a factor of two or three. Sensible systematic reporting on 'Scope 3' emissions in particular is largely untested, and the challenge is not helped by the natural lack of collaboration among competing commercial providers. Index providers have proprietary methodologies to protect which results in 'black box' methodologies in which both accuracy and the inclusion of forward-looking metrics is difficult to understand. If index-provider carbon footprint or other ESG metrics such as board diversity become the default basis for deciding asset allocation, and if they capture only the now and not the future, we dramatically increase the chance that appearances will triumph over impact. It is essential that we don't go down the 'climate reductionism' route in which the whole systemic problem is reduced to simplistic metrics and soundbites, and investors think that by hitting those metrics serious problems are being solved.

Real progress needs real action in the real world: ESG is a particularly dangerous area for the investment industry's obsession with numbers to flourish, and a true understanding of these real-world issues is not going to flow from the usual babble of financial market commentators. For this reason Baillie Gifford engages with and funds a wide variety of third parties, large and small, working in fields such as the Ethics of Artificial Intelligence (Santa Fe Institute); the Sustainable Finance Center (Toulouse School of Economics); Technological Revolutions and Deep Transitions (University of Sussex); and Climate Positive Farming (James Hutton Institute). This is not simply good corporate citizenship, it's a hugely valuable source of insight as we think about how to invest for our clients amidst unprecedented change and global systematic challenges.

7. The International Organization of Securities Commissions says it is exploring whether it can speed up the creation of accounting standards so that ESG factors disclosed by companies can be understood and compared across the world.

Divestment…

Proponents of the divestment approach argue that the cost of capital for less environmentally friendly firms will rise as investors push down their share prices and that the market will therefore in time drive company-level commitment to ESG factors. This is theoretically valid and probably does drive improvements among listed companies. More enlightened companies care about who their shareholders are and about being an attractive employer, and may commit to ESG improvements to satisfy these pressures. But in the real world many investors don't attribute a cost to externalities, have short investment horizons, or are hobbled by regulation (environmental, fiduciary or otherwise). Companies in maturing industries often don't need external capital at all, and private equity investors can take companies off-market altogether where scrutiny of their ESG behaviours is much more difficult. In short, we're not saying divestment is pointless in tackling ESG issues, just that it's limited in its real-world impact. This is reflected in one of the draft IIGCC framework guidelines with which we do agree: "… an exclusion and divestment policy is not recommended as the primary strategy to align a portfolio".

…governance for growth…

Most capital deployment happens within companies. Management chooses what projects to invest in. Engaging with company management on ESG matters (or indeed more generally) is therefore the most tangible way to effect change in the real world. The trick here is to find businesses with really meaningful opportunities to make a difference and a business model or customer base that will reward them for it financially. It also requires management with the mindset and alignment of interests to resist today's short-term shareholder pressure for instant gratification, in return for tomorrow's higher profits. Trying to persuade management to invest on a five to ten-year horizon when it fears being fired by shareholders with quarter-to-quarter horizons is really difficult, and probably pointless.

So ESG-friendly governance is not just about one-to-one discussion with management, it requires a general appreciation of long-termism across all shareholders. The world would be a better place if we could create such an environment, but the reality is shareholders are currently very far from unified in how they think about the long term. We in the investment industry can help by doing a far better job of explaining to investors why non-financial factors are very important to their expected long-term returns.

At Baillie Gifford we take the view that it's more productive to identify the relatively small number of companies that have the management and mindset to incorporate ESG matters into how they design their business. To us this is just long-termism as it always has been. We can then contribute to helping potentially great companies fulfil their ambitions by encouraging management to stay focused on the horizon and to invest for sustainable growth accordingly.

Rather bizarrely in the tick-box world of governance, the very act of only investing alongside management that we support can lead us to be marked down by external governance scorers. In practice we are less likely than some others to oppose management through proxy votes because we try only to invest in companies where we think we share values and horizons. We underperform others on the 'G' because we don't oppose enough votes. Whereas what's really happening is we see little merit in investing in companies where we know we will have to constantly battle short-term management to achieve good outcomes for shareholders in 10 years' time. What gets measured gets managed.

…and (self?) regulation

Perhaps regulation gets a bad rap. In general, those we elect to run the systems that govern us are genuinely trying to make our lives better. The word is often found alongside others such as 'unnecessary', 'red tape', and 'bureaucracy' and in some cases this will be well justified because the cure can be worse than the problem (the destruction of DB pension schemes in some jurisdictions spring to mind).

But sometimes regulation is necessary, and never more so than in reining in the ability of businesses to force their external costs onto society. The most obvious and pressing example of this is of course greenhouse gas (GHG) emissions, global warming and the resulting ever more frequent extreme weather events.

Companies in developed markets have been spewing noxious gases into the atmosphere since the industrial revolution. Regulation can make a meaningful difference in such circumstances. Enforcing a price for GHG emissions that reflects their real costs would very significantly alter behaviour patterns, but the challenge is the mismatch between electoral cycles and the timescales over which such regulation would benefit individuals. There's also the problem that global standards are notoriously difficult to create and police. It's very hard for a government to get elected by impoverishing its people more than the next country on the altar of environmental standards. Just look what's happening to the Brazilian rainforest.

The reality is that for less-developed countries, the foregone social progress that very high carbon pricing would incur – particularly related to infrastructure[8] – would likely do more harm than bring environmental benefit. People need comfortable living standards before they willingly incur the costs of creating a better environment for the next generation. If the environment is a global problem, then so is ensuring social progress and tackling inequality. It's not enough to view the costs of higher environmental standards through the prism of the already-developed west, but it's not a binary subject either: rapidly developing technologies are facilitating social progress and wealth creation around the world with lower carbon intensity in any case. This multi-dimensional interaction between different countries, social systems and myriad environmental factors adds degrees of complexity that need to be included in our thinking about what's 'right' in an ESG context (see the Rio Tinto case study on the next page). In some cases, companies that are in a position to do so have unilaterally decided to do the right thing anyway: Microsoft for example has an internal carbon pricing mechanism which forces all employees to incorporate a much more realistic (and rising) carbon price into their decision-making.

8. At Baillie Gifford, we no longer see energy production as the main lasting challenge to the environment. In many parts of the world, renewable energy sources are already starting to become cheaper, without subsidies, than fossil fuel-based energy. The transition is still in its early stages, but it's coming.

ESG example: Rio Tinto – controversial investment, or central to driving progress?

At Baillie Gifford we invest in the mining company Rio Tinto on behalf of some of our clients. Taken at face value this may surprise in the context of the ESG factors we build into our process, but we think this is a good example of where wider perspective and company engagement can be more effective than simply rejecting the investment opportunity.

ESG considerations

All scenarios for a future low-carbon economy require a transition to renewable energy networks that are built using high-grade steel (of which iron ore is a key ingredient), aluminium and copper. Wind turbines, rail networks and other climate-friendly developments require raw materials. We cannot transition to a low-carbon economy without these raw materials, of which Rio Tinto is one of the lowest-cost producers. The company is run in a disciplined fashion, and has cost advantages over its peers through its leading role in the deployment of autonomous trucks, driverless trains, unmanned drills and drones which improve both safety and productivity.

Rio has been heavily criticised for an incident in May 2020, when it destroyed two ancient rock shelters in Western Australia. Rio had obtained all the necessary permissions and had engaged with the local community, but as the site was investigated it became clear that one of these was of the highest archaeological significance. At this point Rio should have revisited its plans but because of a lack of escalation procedures for this situation the operation went ahead. When this came to light, various senior executives resigned and a review was held. The primary finding was that 'heritage management' should be treated with the same priority as other risks, such as health and safety. This will ensure that similar decisions in future require executive team sign-off.

Baillie Gifford has had several direct engagements with Rio Tinto management on this topic. We have suggested improvements to how sustainability issues are tackled within the company, the level of focus they receive and that sustainability must be considered at the most senior levels. Rio has also made tangible climate and carbon reduction commitments. The company aims to be net carbon zero by 2050, with a 2030 milestone of 30 per cent reduction in carbon intensity and 15 per cent reduction in absolute emissions. This requires the company to be carbon neutral on all new projects and any growth from 2020.

Rio has also been at the forefront of an initiative to develop a new global standard in the safe management of mine tailings (waste products) and of efforts to achieve public disclosure of all mine tailings facilities. The initiative was born out of the 2019 Brumadinho dam disaster in Brazil. Rio's active involvement – and its successful efforts to bring on board all members of the International Council on Mining & Metals (ICMM) to make it an industry-led initiative – has been very positive.

Finally, the company publishes a standalone annual report detailing its approach to meeting the 10 United Nations Global Compact Principles (UNGC). The 2018 UNGC report concluded the company complied with all 10 principles. This assessment is supported by the findings of two respected external agencies: RepRisk and Sustainalytics, although as noted above we would caution somewhat against relying on such external agencies.

Investment considerations

Possibly as a result of pressure from the above issues, we believe that the shares of Rio Tinto are undervalued considering the opportunities the company has before it over the next five to ten years. At the time of writing the shares trade on a low multiple of depressed earnings which we believe is far from capturing the company's prospects as we transition to a low-carbon economy. The key takeaway is this: the products that Rio produces are not optional for this transition. Someone will have to produce them.

From an ESG point of view is it best to avoid this apparently environmentally damaging industry, or is the more responsible course of action to work with the best-in-class producer, encourage it to improve its operating practices and seek to minimise the impact of this necessary activity? The costs of not doing so potentially include poorer mining standards, more environmental damage, and slower progress towards the low-carbon economy we all need. Looked at this way, and where clients share this perspective, engagement looks a much better option for society than simply excluding the company from our investable universe.

An **Actual** approach to progress: ESG as an opportunity, not a problem.

If divestment has limits, governance is misunderstood, and regulation is challenged by competition and historical international fairness, where do we turn? Here, investors can fill the gap. If governments can't do it, large scale investment management firms can. But we really need to get better at explaining some form of our unifying theory to clients.

In the short run, adding back a realistic carbon cost to a company's profit and loss account makes it harder for investors to find companies that are attractively priced. Harvard Business School has been working on an Impact-Weighted Accounts Project which finds that many companies are creating environmental costs that exceed their total profits[9]. Of the 1,694 companies looked at, the study found that 252 firms (15 per cent) of companies would lose all profitability if external impact costs were included, and 543 more firms (32 per cent) would see profitability reduced by 25 per cent or more. The major casualties of this are fairly predictable – airlines, construction, paper and forestry products, electric utilities, construction materials and packaging firms.

But the real question is what do we do with this information? Our global society is so designed that it needs the things those companies produce. We have international supply chains that need airlines. Knowledge needs shared, and despite digitalisation a lot of it is still shared on paper. Food needs to be packaged. Roads, bridges and buildings need to be built – especially in developing countries. The crucial issue then is clear: we need to go about reducing the impact of these activities rather than trying to pretend we can do without them. This is where the quantitative snapshot of companies fails us. It's also where a thoughtful approach to sustainable growth not only mitigates ESG problems, but meets investment opportunity.

At Baillie Gifford, we call ourselves not just active but Actual investors. What we mean by this is that we don't believe the world (or our investment task) can be reduced to numbers. We especially don't believe that the quantitative analysis of financial markets has any power to drive change for society, whether in terms of economic productivity and improving living standards or (related to that) by ensuring the world remains fit to live in. Complexity and uncertainty are facts of life and can't be understood by extrapolating the past into the future. In the long run, companies which meet the demands of society will be those that will succeed financially. The capitalist motive isn't the enemy, it's the mechanism that both incentivises and harnesses human creativity. But we must remember that for sustainable progress to be achieved we must think long term and assume that companies which create harmful externalities will be held accountable within a relevant investment horizon. Such an approach may be messy and difficult to quantify, but the full integration of ESG factors and principles into investment analysis, and a focus on explaining the rationale in each case, is a necessary step towards our unifying theory.

9. https://hbr-org.cdn.ampproject.org/c/s/hbr.org/amp/2020/09/how-to-measure-a-companys-real-impact. This project was initiated by the Global Steering Group for Impact Investment and the Impact Management Project. Baillie Gifford amongst others are advisers to the latter.

Asymmetry, more than ever

We've written many words elsewhere on the importance for long-term growth investors of recognising that the vast majority of wealth creation – and in the long run, stock market returns – comes from a very, very small number of companies[10]. This principle surely applies now more than ever: the companies that are able to facilitate society's transition to a more sustainable ecosystem will displace huge swathes of outdated incumbents. Data science and image recognition technology will drastically reduce harmful use of pesticides. Synthetic biology will help overcome our addiction to non-biodegradable plastics and reduce the pressures of rising meat consumption. Autonomous electric vehicles and delivery drones (powered from sustainably generated electricity) will change the way we think about transport, with enormous ramifications for the vehicle and retail industries, and possibly how we consume food and reduce waste in the food chain[11]. Mass online learning will allow a jump in general levels of education with associated productivity gains. A big factor in raising standards of living is effective, reliable and affordable healthcare. As our understanding of genetics grows so will our ability to cheaply and effectively target preventions and treatments. One company in which Baillie Gifford currently invests, Zipline, delivers time-critical medical supplies via drone in Rwanda, Ghana and elsewhere – just one small step in helping to move care standards there towards developed-country standards. We've long been fans of the wonderful (now sadly departed) Hans Rosling, who spent much of his later years explaining the importance of the provision of better basic healthcare in developing countries. This is a huge factor in tackling the explosive population growth of the past few decades that has itself been the root cause of so much strain on Earth's resources[12].

In short, the need to create a more sustainable global economy isn't a problem for investors, it's central to our opportunity. There is reason for huge optimism.

10. See for example www.bailliegifford.com/lets-talk-about-actual-investing at pages 12–13.

11. Some studies have shown that 'unwrapping' food in order to save packaging actually creates net environmental damage because it creates significantly more food waste that, for certain food types, outweigh the direct packaging savings. See here for a useful summary of the issues: https://onlinelibrary.wiley.com/doi/full/10.1111/jiec.12743

12. This is an excellent and optimistic explanatory film: https://www.gapminder.org/videos/dont-panic-the-facts-about-population/

What does this look like in practice?

At Baillie Gifford we have not inserted climate change or social equity as separate factors in our investment processes across the firm. They've always been there as considerations within our long-term investment horizon. We don't generally expect environmentally damaging or socially irresponsible companies to escape unscathed by regulators or customers, so we don't see them as attractive long-term investments.

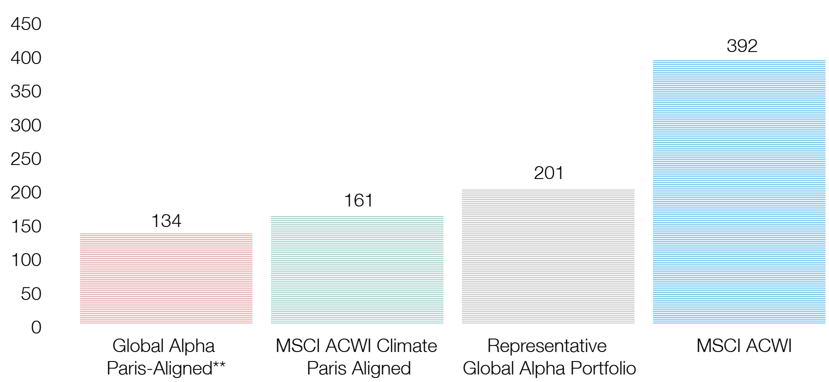
We can though, particularly for carbon footprint, retrospectively analyse our portfolios against external measures. Given the discussion above, we think this is an over-simplification of the challenge but we see no harm in examining and reporting on it. For this purpose we produce below the greenhouse gas (GHG) intensity analysis of one of the firm's flagship global equity strategies, showing both the mainstream version and a specifically Paris-Aligned version of the strategy.

The chart shows that the mainstream portfolio – that is, one that has no explicit greenhouse gas emissions targets and no carbon goals – has just over half of the GHG intensity of the standard MSCI All Countries World Index, although it has a quarter more than the Paris-Aligned index. The Paris-Aligned version of the strategy, which specifically commits to being lower than the Paris-Aligned index, has a GHG footprint which is 83 per cent of the Paris-Aligned index and only 34 per cent of the mainstream index.

The key takeaway is that a long-term portfolio of great growth ideas naturally has a low carbon footprint, because growth comes from meeting the demands of society to do things in new and better ways. Right now climate change is a key driver of that. We see this as supportive of the thesis that true long-term growth investing does not need to be significantly adapted for a world of ESG. We may need to commit to staying below certain levels for certain strategies, and we certainly need to report more thoroughly on GHG considerations, but long-term growth is unlikely to co-exist with unacceptable environmental behaviour[13].

Much more important is the need to produce comprehensive reporting and commentary for clients on how the much more complex reality of ESG factors is embedded into our investment activities, and how we are seeking to drive change – not just tick that box. This is no small task and because it's subjective, it's not something that can be done in isolation from our portfolio managers. But our clients are right to ask us to prove ourselves, so we are working hard and making progress. A crucial point though is that the production of a range of non-financial metrics should be seen as the starting point for a discussion, not targets in themselves. This applies in our relationships with companies too, which often ask us "what metrics would you like to see?" Our preferred response is to turn this question around and ask the companies what they see as the main ESG risks that apply to them, and then show us how they are making progress to mitigate those.

Weighted Average Greenhouse Gas Intensity
(tCO_2e/$m EV*)



Source: Baillie Gifford & Co, MSCI ESG Research. As at 31 December 2020. These numbers have not been adjusted for an inflation in enterprise value.
*Includes cash.
**Based on a model portfolio.

13. Baillie Gifford is starting to roll out Paris-Aligned versions of some strategies. We see this as providing reassurance to clients rather than changing what we do. Though it necessitates some additional analysis, in practice it rarely makes a difference to client portfolios in which long-termism is already embedded.

ESG and ‘purpose’ in the savings and investment management industry

Since we wrote *Let’s talk about Actual investing* in 2018, the UK regulator has gone through a consultation exercise with the financial services industry, which led it to publish a discussion paper entitled *Transforming Culture in Financial Services – Driving Purposeful Cultures*[14]. This was a very interesting exercise in which the investment management industry – within the wider financial services context – turned the spotlight inwards to ask ourselves ‘what are we for?’ What do we, or at least what are we supposed to, contribute to society? This question is inextricably linked to the overall ESG theme of this article. Socially responsible investing has become core to what many of our clients expect of us, and it also defines our purpose. It’s probably always been core to what many individuals expect of us, and our lack of attention to it has no doubt contributed to the very low levels of client trust that exist in the investment industry.

We should be looking at the focus on ESG as an opportunity for a reset of relationships with our clients. We need to offer better, more holistic explanations of why and how we deploy capital in the way that we do. We need to explain how (at least some of us) engage constructively with companies, encouraging them to produce solutions to society’s challenges and drive progress. We need to explain on what timescales we are working, to show we understand our broader obligations to help sustain a world worth living in.

In summary, we need to be accountable for something very much more than just betting against each other in financial markets and hitting artificial targets. We need to be accountable for real world progress.

14. Baillie Gifford participated in the asset management working group. It can be found here: https://www.fca.org.uk/publication/discussion/dp20-1.pdf

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