EXPLORING SUSTAINABLE GROWTH: A NEW APPROACH TO ESG

INTERVIEW WITH STUART DUNBAR

MB – Malcolm Borthwick

SD – Stuart Dunbar

MB Hello and thanks for joining us. I'm Malcolm Borthwick, editor of Intellectual Capital at Baillie Gifford.

The investment industry is awash with talk of environmental, social and governance or ESG issues, and other terms such as stewardship, impact, and responsible investing. The danger is that we end up with a form of ESG reductionism, where the subject is reduced to simplistic metrics and soundbites, so how should we navigate these complex and uncertain issues?

I'm joined by Stuart Dunbar, who's a partner at Baillie Gifford, but before we start the conversation, some important information. Please remember that as with all investments, your capital is at risk, and your income is not guaranteed.

Stuart, welcome back to *Short Briefings on Long Term Thinking*. We spoke about a year ago on this podcast about Actual investing, and what we at Baillie Gifford mean by this, and you've just written a follow up paper to this about Actual ESG. Let's start by talking about what we mean by ESG, how would you define it?

SD So ESG is widely accepted as meaning environmental, social and governance issues, obviously that means how you operate your company, how your company impacts society, and how your company impacts the environment. And it's become a bit of a catch-all for thinking longer term and specifically looking at these issues in the context of making investment decisions.

I think it's helpful. There are loads of other terms - responsible investing, impact investing - all sorts of variations on a theme, but ESG probably does capture these types of issues. One rather nice phrase I did hear a colleague using for us recently is "ESG should actually stand for Exploring Sustainable Growth".

Now, that may not apply to every company, but I think that might be quite a nice way of thinking about what we're trying to do at Baillie Gifford.

MB And how do we look at ESG at Baillie Gifford?

SD I think it's a resource intensive, complex, system-wide consideration. Now, that may sit uneasily alongside the fact that all our investment decisions are made at company level, but I think the two are not inconsistent.

In the paper I talked about the great difficulty of marrying the top down view of ESG with the bottom up company view of ESG. The challenge there is that what looks right to an individual investor, as in 'don't invest in miners', or something, because they scar the landscape, very much doesn't look right from the perspective of meaningfully investing in a way to facilitate a carbon transition, for example.

We are very wedded to the idea of disruption and growth. The types of companies that we look for, regardless of ESG factors, are those that are finding newer and better and more efficient ways of satisfying the needs of people.

And the growing focus on ESG factors, and E in particular, I think is where we're going to find many of those disruptive opportunities. And some of the very best growth opportunities for the next 20, 30 years are going to be those companies that are able to go through this carbon transition in a positive way, finding solutions to answers, not just avoiding the problem by not investing in green assets or something of that nature.

So, sorry, long answer. But it's really, fundamentally, about not reducing it to snapshot metrics, which I don't think capture the process of change.

MB And it's often reduced to snapshot companies as well, and supply chains are often overlooked. So, for example, building a single 100-million-watt windfarm requires 30,000 tonnes of iron ore, 50,000 tonnes of concrete, and 900 tonnes of non-recyclable plastic. How do we look at ESG in a wider frame, so it's not just picking out individual companies?

SD I think a lot of this is about considering the purpose and consequences of what companies are doing. So, in that particular instance, nobody has yet told me how we can build a windfarm without all of those materials that you just talked about. Now, part of the carbon transition is trying to find better, less polluting, less resource-intensive ways of doing things. So, that's part of it.

But on the other hand, if a company, say a miner that digs up iron ore, is absolutely crucial to producing the raw materials for those wind turbines, then it really doesn't make sense to simplistically say "well, we're not going to invest in mining companies, because they deplete the world's non-renewable resources", when they're in fact an absolutely crucial component of how we get to this more sustainable economy.

I think the missing part in the conversation is very often trying to include the consequences of the activity that we see when in many cases that's by far the most important thing.

MB And Rio Tinto, which Baillie Gifford invests in, is a good example of that. Because there was a lot of controversy with Rio Tinto when they blew up a 46,000-year-old Aboriginal cave system. So how have we engaged with a company like Rio Tinto, for example?

SD I think that's a really interesting example, because I think we met with Rio Tinto something like six times in the year after they got themselves into quite a difficult position. And again, to be clear, mistakes were definitely made. This is not a defence of what they did.

But the far more useful conversation, rather than condemnation, is to engage with management, find out if anything went wrong, indeed what went wrong, and how they treat, in this case, heritage considerations. Are they treated at senior levels within the organisation? Is there some sort of misalignment of incentives that means that they don't care about destroying cultural heritage, for example?

Now I don't think any of those things were true. I think what happened is, as can happen in large companies, as the situation developed, Rio did not step back and reassess the work that they were doing in Australia, when perhaps they should have done. We then discussed on several different occasions, with everyone from the chairman on down, about how to put in place internal control mechanisms that better balance the interests of, simplistically, digging iron ore out of the ground on the one hand, and protecting the world's cultural heritage on the other hand.

And they have now put in place much better internal mechanisms to make sure that they balance those conflicting goals much better.

On top of that, companies like Rio are trying very hard to be as responsible as they can be. Rio has made tangible climate and carbon reduction commitments; they're aiming to be net carbon zero by 2050. They have 2030 milestones in place. They've been at the forefront of various industry-wide initiatives around safe management of waste products, these types of things.

If we go back to the starting point, that miners are necessary in the carbon transition - by the way, not all miners, maybe some from thermal coal would be in a different place, but speaking here about iron ore in particular - the same argument would apply to other precious metals. It's far better to understand these companies, talk to management, and help them to do what they do in the best possible way.

MB There still seems to be an element of 'sell bad stocks, buy good stocks.' But it doesn't seem to always be the most responsible course, just to disinvest in a company. Easy, but maybe not the right option.

SD Absolutely, that's the case. In some cases, if a company is not best in class, and not committed to improving, let's call it, the quality of their operations, by which I just mean incorporating broad ESG characteristics, and not particularly engaged, then I think at some point you do need some kind of milestones. And the ultimate sanction is to not provide capital to that company.

Even then, you do run into this sort of collaboration challenge. Just because we eventually decide this company's not acting responsible and is not changing, selling the shares doesn't necessarily achieve very much, it just shifts the problem. It quite feasibly means the buyer of the shares may well be somebody who cares less than we do about the responsible operating practices of an individual company.

So, if you go down that line, what have you achieved? You've very probably made things worse. Now, there's a gap here, between the understanding of investors as to what responsible investing means and the reality of what responsible investing means. Now to be very clear, there are very thoughtful, forward thinking investors out there. Many people do understand that divestment is not really the most effective approach to tackling these very big challenges we have.

But equally, I think there's a very big communications exercise that the industry needs to undertake to help people to understand that. We see regular examples of protestors who observe that a public sector pension scheme, for instance, invests in oil companies, and simplistically people walk around with banners. And again, let's be fair about this, it's very well intentioned. But it doesn't really do anything at all to solve the problem.

What would you rather do? If everybody feels compelled to sell out of, say for example, oil companies, and their share prices are very negative as a result, and somebody takes them private, for example, all you've done is you've changed the ownership structure. You haven't necessarily addressed any underlying problems. And what if, as may very well happen in the next 20 years, the oil majors are in actual fact a driving force behind the decarbonisation of the economy?

I don't think we would really argue that that looks like it's happening at the moment, but I don't think we should rule it out forever. So that's just an example of something that needs a lot of thought and a lot of consideration. And to just say "we don't want miners, we don't want oil, we don't want airlines, we don't want all sorts of other stuff", it doesn't get us very far.

MB We've seen a big increase in ESG ratings, where ratings firms analyse whether a company meets various scores based on measurements such as human rights, emissions and governance. Are these ratings a helpful guide?

SD There's a huge proliferation of indices out there now which purport to allow people to invest in ESG-led strategies which correspond to their own sense of importance in terms of the most important things to tackle.

Again, we're an active manager, and in some ways, we would bash the passive index managers, wouldn't we? That may or may not be the case, but I think there's a much most important point here, which is those metrics-based, measurement-based approaches to responsible investing don't capture the process of change adequately.

And I do worry that there's huge amounts of money flowing into passive ETF and ESG type funds. I think there's a meaningful danger, if you look at what's in some of those funds. Not all of them, but many of them. For example, if you look at Refinitiv data, the top 30 highest ESG scores globally, from memory, include two tobacco companies in the top 10 names.

Now, going back to the point, for some companies it's very hard to justify their existence at all. I think many ESG investors would be very surprised to learn that when they invest in whichever S&P index that uses Refinitiv ESG ratings, that they would have two tobacco companies in the top 10 holdings, for example.

I worry that people think they've solved the problem by investing in ESG-friendly strategies that have very simplistic approaches. And I would go so far as to say that might be worse than doing nothing, because if you think you've solved a problem, you'll stop paying attention to it. And what really matters here is environmental sustainability, and just transition, and social equity.

That's what most people, I believe, think of when they're talking about ESG. If they think that they have invested in a strategy that is tackling these things, when in actual fact it's not really tackling them because it's not capturing the process of change, I would argue that's almost worse than doing nothing.

One of the things I'd like to emphasise, though Malcolm, is that I'm not suggesting here that ESG ratings are wrong in any way. They may consider different issues, and they may come back up with different answers; there's nothing wrong in incorporating that into an investment process.

A key point here is that you have to understand what it is they're trying to tell you. I don't think it makes sense to simply translate that into some sort of passive fund in which you line up the companies according to their ratings. We have to use those inputs in a thoughtful way to help us get to a balanced judgement of what a company has to offer, in the context of the ESG issues around that.

MB It seems odd that a lot of these ESG ratings or scores don't really have much to do with the product or service that the company is operating or selling.

SD Yes. Tesla, for example, I think scores more lowly on ESG considerations than Boeing, just to pick a couple of examples. Actually, it scores lower than General Motors as well, I think. So, you look at that and think, well, what's that? What's in that bit of information?

And what it does is it captures the existence of certain policies. So, if you're a longstanding company and you've been under regulatory scrutiny for a period of time, you are going to have social policies, D&I policies, environmental policies, use of water policies, any number of things, and that will count very strongly for you in your overall ESG score. And rightly, because these companies are considering their impact on the world.

If you take a company like Tesla, which is a younger company, somewhat more entrepreneurial, a bit less traditionally organised, shall we say. Led by, obviously, a quirky leader and entrepreneur. The younger nature of that firm means it scores less highly on traditional organisational ESG measures, if you like.

But what that completely fails to take into account is that Tesla has undoubtedly done more to totally change the direction of the automobile industry into, sometime-in-the-now-visible future, being overwhelmingly electric. But that's simply not captured anywhere.

There can be very high carbon footprint companies that entirely justify their existence. There can be very low carbon footprint companies that are achieving much less in terms of contribution to society or contribution to a more sustainable world. But that just doesn't really figure in the numbers at all.

MB Given there's no one size fits all solution, it's hard to quantify ESG. How do we measure progress?

SD I think that's judgement. How do you do it? I guess you look at what a company is producing; who's buying it, what are they using it for, what's it displacing? How does it fit within a much broader ecosystem, moving towards a more sustainable approach? What impact does it have on social fairness? What impact does it have on the environment? These things are all judgements. Particularly, if, as we do, you focus on investing in growth companies, when a lot of those positive societal contributions are likely to lie in the future, as disruption and displacement happens across a wide range of industries.

One of the really big challenges we have is that it's almost immeasurable. It's far more important. These forward-looking contributions to sustainability are way more important than what a company's carbon footprint is this year.

That's not to say the latter is unimportant. But that doesn't solve tomorrow's problems. The challenge is how do you explain that to people? You can do it in a narrative way; we try and engage a lot with our clients about our thinking, how it's particularly difficult and doesn't lend itself to some sort of ESG metrics scoring.

And that comes back to this educational part. It's funny; at one level it's a very complex subject, at another level it's really quite straightforward. All we're saying is that it's far more useful to focus on the companies that are enabling our sustainability transition, by deploying capital into new and better ways of doing things, than it is to simply focus on who happens to have a low carbon footprint at the moment.

I would really encourage everyone to start thinking that way. If we come back to your steel and concrete example, we are not going to be able to do without steel and concrete in our carbon transition in the next 20 or 30 years. And yet there is very little investment going into industries like that, to find much less environmentally damaging approaches to the production of steel and concrete.

Wouldn't it make a lot more sense to be investing in these industries, rather than simply scoring them out using some sort of exclusion-based approach, which deprives those examples of the capital they need to actually create a cleaner environment?

It's a slightly reversed way of thinking, and I would certainly encourage everybody to think a bit more carefully. How do you make things better if you ignore their existence?

MB Thanks very much for joining us on the podcast, Stuart.

SD Thanks very much for having me, and always a pleasure, and I hope that people find it interesting.

MB And if you would like to read more about Stuart's thoughts about the rise of ESG, you can find his paper *Actual ESG* on our website at bailliegifford.com/insights.

And many thanks to Lord of the Isles for the music. The track we've used is called *Horizon Effect*, which is released on Permanent Vacation. And if you're listening at home, if you're listening in the car, wherever you're listening, stay well, and we look forward to bringing you more insights in our next podcast.

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