E + S + G factors are fundamental to better portfolio outcomes

Amanda McCluskey | Stewart Investors | 18 August 2017

Sustainability issues – climate change, global food shortages, water shortages, and poverty, as well as safety, management and governance scandals – are now daily news headlines. Sustainability is relevant to making any allocation of capital. It is not intangible; it can be assessed at all levels of an investment process to allow for identification of elements of quality as well as less obvious risk. Ensuring your investment process incorporate these sustainability factors all add up to better outcomes.

WHAT IS SUSTAINABLE INVESTMENT?

There are a raft of different approaches to sustainable investment. Fundamentally, they are all driven by a belief that sustainable development challenges present both risks and opportunities for companies and sectors.

The root causes of the sustainable development challenge are numerous and complex. They include population pressure, land and water scarcity and degradation, resource constraints, income inequality, ethnic and gender inequalities and extreme levels of poverty. In order to tackle these challenges, both developed and developing countries will have to shift from a resource-intensive, consumption-driven, debt-dependent model of development and growth towards a more sustainable one. At present, humanity is using up natural resources at a 50% faster rate than nature can regenerate.[1] The challenge for all societies is to shift their development paths to reduce the ecological footprint while improving human development outcomes. Companies play a huge role in helping achieve that.

Sustainable investment is by definition changing the investment process to allocate capital based on these challenges. The most simplistic way is to screen out particular companies or sectors, such as tobacco and fossil fuels. Other investors may take a quant-driven approach and re-weight their portfolios based on sustainability scores or rankings. Some investors will positively screen or invest thematically, intentionally allocating capital to companies or sectors they believe will benefit from the sustainable development challenges – for example, clean tech. Another approach is to own "bad companies" but engage with them to encourage them to change their behavior or become more sustainable. There are many different ways to the top of the sustainable mountain, and integrating a consideration of the sustainable development challenges at every step of the investment process is arguably the best way to realise the benefits of the insights.

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SUSTAINABILITY ISSUES ARE TANGIBLE AND MEASURABLE

Sustainability can be assessed at all levels of an investment process. It can feed into assumptions on growth and risk and, most importantly, the assessment of quality. Many investors rely on a Discounted Cash Flow (DCF) to inform their buy, sell or hold decision. In modelling a DCF, investors need to make assumptions around risk and growth. For instance, to understand how many more cans of coke can be sold, an investor needs to have an appreciation of sugar taxes and trends towards healthy eating. In order to comprehend the profit margin of the bottler, they need to know about regulatory developments around waste management and what that does to the price of packaging. They also need to recognise the cost of water and risks around water availability. These are all sustainability issues.

Further to understanding risk and growth, perhaps the single most important step in the investment process is to assess the overall quality of a company. The best investment decisions are made by identifying those companies most likely to fulfil their long-term sustainable development potential and avoiding those companies most likely to fall by the wayside over time. To achieve this, the quality of management, financials and franchise, as well as sustainability factors, need to be assessed.

MANAGEMENT: COMPANIES KILLING THEIR EMPLOYEES ARE CLEARLY NOT WELL MANAGED COMPANIES

There are a range of Environmental Social and Governance (ESG) metrics that serve as excellent proxies for quality of management. Human capital performance is critical, and indicators such as employee compensation, employee turnover rates and safety records can be particularly revealing.

In addition to more tangible metrics, quality can also be assessed by reviewing the management team’s attitude towards ESG issues. Asking senior management how they are managing an ESG issue provides insight into how they are running their business. For instance, asking about a company's approach to reducing greenhouse emissions provides a good insight into how they are managing energy price risk, as well as input costs more broadly. Further, it serves as a useful measure on the ability to develop and execute successful long-term strategies. Discussions centred on sustainability also provide insights into the timeframes of the management team. Many modern management teams appear to have lost all sense of purpose or dharma (the Sanskrit word often translated as ‘purpose’) in their search for short-term returns. Finding evidence of dharma is a key long-term competitive advantage.

The existence of poor quality management can break the case for investment into a company that might appear sustainable on the surface. Many companies that appear to be well-positioned in terms of their sustainable development stance can struggle to fulfil their potential over time because they are fundamentally poor quality businesses, or are run by

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poor quality management teams. Unfortunately, this is the case with a number of companies that are in the renewables space. For instance, a company that recently listed came into being because of a desire to minimize tax. An accelerated depreciation scheme allowed companies to write off 80% of the renewable plant cost in the first year against any income stream. Further to that, the company holds no intellectual rights nor did they invest anything in R&D, one of the founding family took home 4% of profits as a royalty, they built up the industry's largest land bank at 1/27th of the amount it would cost competitors, and as of 2013, there were three criminal, six civil, 13 tax and six labour charges outstanding against the promoter. Since listing, the share price is down significantly (Figure 1). So despite the premise of the business being a compelling one, the quality of the management team did not support the prospect of a successful long term business.

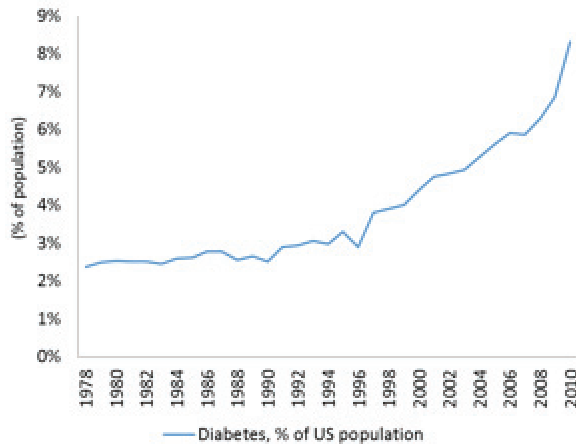
Figure 1: Renewable Energy Company, Share Price since IPO
July 2015 – July 2017

Source: Bloomberg.

FRANCHISE: IS THE PRODUCT ACTUALLY NEEDED BY SOCIETY?

When forming a view on quality, it is essential to make an assessment on the strength of the franchise. Sustainability insights help with this – for instance, considering the social usefulness of products. Companies that have a high percentage of products or services that are actually needed by society are more likely to deliver less volatile performance and will face fewer risks to their licence to operate over time. A good instance of this is reviewing consumer companies with sales dominated by products containing high levels of sugar, salt and fat. It is possible to argue they have a weaker quality of franchise, when looked at through the lens of social usefulness. Consumed in excess, such products have negative externalities for society through increased health costs. The increasing rate of diabetes in the US (Figure 2) cost the economy USD245 billion in 2012 alone.[2]

Figure 2: Instances of Diabetes in the US
1978 - 2010



Source: CDC/NCHS, National Health Examination Survey cycle I (1960–1962); National Health and Nutrition Examination Survey I (1971–1974), II (1976–1980), and III (1988–1994), 1999–2000, 2001–2002, 2003–2004, 2005–2006, and 2007–2008

In theory, this should dampen demand in the longer term, but more significantly, attract considerable negative attention from regulators, politicians and concerned stakeholder groups. Such companies are likely to face greater headwinds, from advertising controls and regulatory scrutiny, to potentially damaging community campaigns. On the other hand, consumer companies that focus on selling healthier foods or consumer staples such as toothpaste, soap and shampoos tend to have a stronger quality of franchise when viewed through this lens.

Turning to the finance sector, it is arguably prudent to avoid banks that generate a significant part of their profits from proprietary trading, and listed stock exchanges that regard their high frequency trading strategies as a key growth driver. In many markets, greater prudential regulation is needed to rebalance the financial sector. Companies that recognise the requirements of their implicit social contract will not face these headwinds. Those most likely to benefit from tailwinds will be traditional savings and loans banks that have maintained the trust of depositors, customers and society. Access to equitable finance for all in society is critical to escape poverty and those organisations able to serve the bottom of the pyramid responsibly are also arguably well placed to generate long-term shareholder value.

Increasing environmental concerns are also impacting the usefulness of products. Environmental positioning is partly about opportunity but also about how risk is considered and managed. A company that, all else being equal, can generate higher economic returns per unit of 'environmental resource' will be better positioned than its peers over time.

Environmental performance metrics help build a more complete picture of the long-term sustainable development positioning of companies. This is true across a range of sectors, from food and beverage producers to utilities companies. Some products will be more useful in the future than others. In the same way that the horse and cart became obsolete with the onset of the car, companies manufacturing ultra-efficient electric motors and filters for cleaning air are likely to make lower risk and higher return investments due to their innovation and longevity.

FINANCIALS: IT IS ALL ABOUT THE NUMBERS AFTER ALL!

In determining what to pay for a company, it is key for investors to ensure they understand how companies might be impacted if externalities are internalised into the financial accounts. This is a slow but steady trend that is occurring, with pricing and regulatory interventions taking place where a business or industry perceived to cause pollution might be charged fines or taxes for causing this, or have new operating standards imposed on them. Both of these outcomes would add to operating costs. Currently, most environmental and social liabilities and costs are omitted from balance sheets and income statements.[3] Examples include the long-term environmental liabilities of many chemical companies or the anticipated legal liabilities facing tobacco companies with irresponsible marketing and sales practices in emerging markets.

A useful case study to better understand how these externalities can impact a company's balance sheet, as well as brand, is the plastics industry. The Great Pacific Garbage Patch is a rubbish-covered region of the Pacific Ocean, several hundred miles in diameter.[4] Eight million tonnes of plastics leak into the ocean each year. It is estimated that some plastic products will retain their original recognisable form 400 years after finding their way into the ocean.[5] Terrifyingly, by 2050 it is estimated there will be more plastic in the ocean than fish,[6] and that is assuming fish stocks remain constant, which is highly optimistic.

While only 26% of plastic is used in packaging, there are big problems with designed obsolescence. Most plastic packaging is single use, so is thrown away and ends up in the ocean, landfills or clogging drains and waterways. As a result, regulators are increasingly developing policy mechanisms that price these externalities, recognising the total cost of plastics is higher. This might be indirectly, through environmental costs being added through the supply chain, such as carbon pricing or direct intervention. It is already being seen with the banning of plastic bags[7] and bottled water. Another measure is forcing companies to pay for the pollution generated from their products – for example, compulsory take-back schemes and levies to offset the cost of reverse vending.[8] Trucost calculates the total natural capital cost of plastic in the consumer goods industry is more than US$75 billion per year.[9] As a result, the value at risk suggests companies would be better placed to reduce their dependency on plastic now to protect long-term margins. There is also the

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potential reputational risk that companies face when there is more plastic in the ocean than fish. Images of plastic bottles floating in the ocean cannot be good for particular brands.[10]

Sustainability insights into the quality of the financials are not just derived from environmental issues. Companies that are too aggressive or pursue irresponsible business practices with their suppliers, employees or customers provide easy pickings for new entrants and have a weak license to operate. As a very quick and crude check for franchise balance, investors can ask whether all stakeholders, customers, suppliers and employees are being treated fairly and look at metrics such as Days Payable (looking at the average number of days a company takes to pay its suppliers) and tax rates paid. These metrics can provide a telling insight into a company's practices and long-term viability.

MANY DIFFERENT WAYS TO THE TOP OF THE MOUNTAIN

These are by no means unique ideas. Many asset managers are now incorporating firm-level Environmental, Social and Governance (ESG) information into their investment process – although all in different ways. The Responsible Investment Association Australasia (RIAA) noted in July 2017 that this movement is a 'major force in the investment industry today'.[11] In Australia, 77 asset managers have become signatories to the UN's Principles for Responsible Investment, which requires a commitment to incorporate ESG factors into investment analysis and decision making processes.[12] This figure continues to grow year on year and shows that investment processes that take ESG into account are becoming a 'key consideration in mainstream investment strategies'.[13] According to both Morningstar and RIIA,[14] the reasons managers are using this approach are to respond to investor demand for sustainable options, but largely because it is seen as relevant to their evaluation of companies. Another driver for this change may also be that ESG consideration aids managers and trustees in meeting their fiduciary requirements.[15]

There are a number of studies to support the conclusion that ensuring the investment process has the flexibility to incorporate sustainability factors leads to improved overall performance. Clark, Feiner and Viehs, in 'From Stockholder to Stakeholder', reviewed 39 studies and found that 80% documented a positive correlation between good sustainability practices and superior financial market performance.[16] That is, more sustainable firms generally outperform less sustainable firms. Another study by Eccles, Ioannou and Serageim assessed the correlation between an aggregate sustainability score and stock market performance over a period of 17 years.[17] It found that a 'high-sustainability' portfolio outperformed a 'low sustainability' portfolio by 4.8% on an annual basis.[18]

Looking more locally, the RIAA Annual Report for 2017 found that over multiple time periods, but importantly the medium to long-term, Core Responsible Investment funds[19] across various sectors outperformed either the index or comparable non-ESG strategies.[20] Specific instances were:

- "Core responsible investment (RI) Australian share funds outperformed the average large cap Australian share funds over three, five and 10 years.[21]
- Core RI international share funds outperformed large cap international share funds over three and 10 years.
- Core RI multi-sector balanced funds outperformed their equivalent mainstream multi-sector growth funds over one, three, five and 10 years".[22]

These results from RIIA analysis, as well as from the sources outlined above, support the argument that taking sustainability factors into account delivers superior performance results over the medium to long-term.

It is also important to note that incorporating ESG factors into an investment process can lead to other ancillary benefits, beyond outperformance. Using their Morningstar Sustainability Ratings to review US funds, Morningstar noted that funds with the maximum Sustainability Rating, also tended to have the highest risk-adjusted return relative to category, better Morningstar Analyst Ratings, lower volatility, and larger exposure to financially healthy companies with structural competitive advantages.[23] Overall, Morningstar concludes that :companies that are doing a good job of addressing their ESG risks and opportunities tend to be quality companies and that funds that have a lot of these types of companies in their portfolios tend to be quality funds".[24]

STILL A VERY LONG WAY TO GO

Despite the positive trends identified in these studies, things are unfortunately not as rosy in reality, and there is a long way to go until mass allocation of capital truly considers sustainable development challenges at each step of the investment process.

The two evidence points that suggest responsible investment is still not truly mainstream is the obsession with the benchmark and the subsequent definition of risk and the persistent observable short-termism.

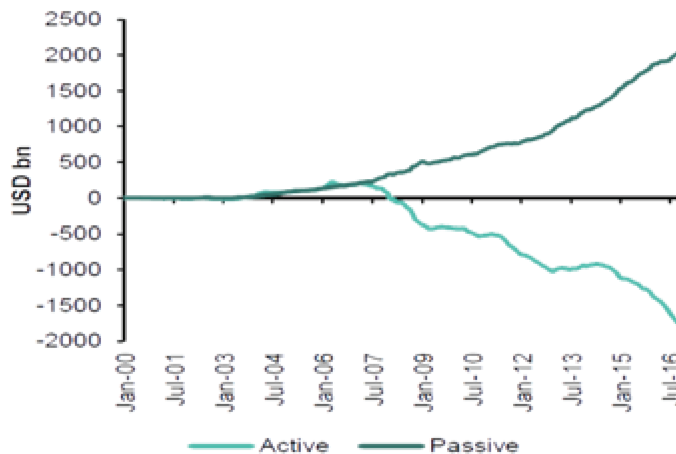
1. The obsession with the benchmark

Risk should be defined as losing people's money, not as a deviation from a benchmark. If you talk to a real person about their retirement savings, they could not care less about what happens to the benchmark - yet society's capital is increasing allocated with the benchmarks front of mind. People are measured against it and paid against. Its impact is endemic.

The flows to passive, ETF and short-term funds evidence this concern. Theoretically, the financial sector is supposed to support the long-term growth of the real economy. However, the long-term, active fund manager is fast becoming an endangered species. Passive funds grew 4.5 times faster that active funds in 2016.[25] Figure 2 complied using Bernstein

Research EPFR data clearly depicts the trend of flows rushing into passively managed options at a steadily increasing rate from 2009 onwards. Simultaneously, active funds have seen overall net outflows over the same period.

Figure 3: Global flows into passive and active funds
January 2000 – July 2016



Source: Bernstein Research EPFR data, 2016

In many ways, active fund managers have been responsible for their own downfall. Short-term incentives, product proliferation and closet index-hugging have all driven clients towards investment that clearly does not factor in the sustainable development challenges. These funds blindly allocate to the index that has exposure to assets that will arguably be stranded in the future.[26]

Defining risk as a deviation from the benchmark and rewarding investors on performance against it has incentivised index-hugging behaviour and investors pay fees when money is lost in absolute terms. A report released by SCM Private in 2015 found that 36% of all UK active funds were index huggers. The 10 worst offenders cost £346 million in terms of underperformance, compared to similar index funds.[27] In 2013, the Danish regulator found 56 of their 188 active equity mutual funds "were not employing the active management strategy set out in their prospectuses".[28]

Sustainable investing driven by benchmarks is not much better either. Many of the world's most "sustainable companies" are deemed as such based on the thickness of a sustainability report that is filled with pictures of smiling children and sunflowers. While screening companies is not the answer, perhaps implementing a principle of "if all else being equal, do the right thing" may start a greater discussion on what to own and what not to own. Thus, very poor quality companies, whose activities are counter to the long-term benefit of societies, are the easy recipients of society's capital. This cannot be a good outcome for

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those interests they are ultimately set up to serve. What is the point of saving all this money for retirement when you cannot breathe the air when you get there?

Surely the point of a financial industry is to strive to allocate capital productively, not to shut its eyes and pass it on indiscriminately. "Smart beta" products are an attempt to address this problem by using computers to pick certain companies based on quantifiable characteristics. The problem is that any assessment of business fundamentals and long-term company potential requires a healthy dose of qualitative analysis and judgment. The feeling that management may be misleading investors or that a company may lean too heavily on unhealthy political connections cannot be captured by a spreadsheet.

2. Short-termism

Increasing short-termism also suggests sustainability issues are not truly being taken into account. Time horizons have collapsed. According to The New York Stock Exchange (NYSE) index data, in 1940, the mean duration holding period by US investors was seven years. This stayed the same for the next 35 years. By the 1987 crash, the average holding period had fallen to under two years. By the turn of the century, it had fallen to below one year. It was around seven months by the beginning of the global financial crisis in 2007.[29]

According to research by SCM Private, excessive trading is adding more than £3 billion a year of hidden charges for UK schemes.[30] They found that UK pension funds had an average portfolio turnover of 128% each year, adding 0.7% in undisclosed costs. The cumulative effect of this over 20 years, it said, would be to shrink retirement pots by up to 15%.[31] If the trend continues, time horizons will reach some kind of perpetual motion, where capital is instantly and constantly recycled around the financial system, without pause.

Arguably this is already the case, given the prevalence of high frequency trading. As Michael Lewis's excellent and frightening book *Flash Boys* highlights so clearly, financial markets today are dominated by speculation, not investment. There are no "liquidity" benefits to society that occur from high frequency trading. As Michael Lewis puts it, liquidity is "one of those words Wall Street people threw around when they wanted the conversation to end, and for brains to go dead, and for all questioning to cease".[32]

The damage wrought by short-termism reaches companies, too. Given their dependence on such short-term, transient, unreliable capital, many listed-companies are under pressure to run their businesses simply for the next three months, rather than the next 10 to 20 years. Unfortunately, despite so many investors signing up to responsible investment codes, it is only getting worse. A survey of CEOs found that between 2013 and 2016, the share of respondents who reported feeling the most pressure to demonstrate strong financial performance within two years or less rose from 79% to 87%.[33] This is impacting the way companies allocate capital, manage their balance sheet and treat their employees. It is

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almost always to the detriment of the long-term interests and addressing sustainable development challenges.

One glaring example of this recently was Kraft-Heinz bid for Unilever. Since the former's withdrawal, analysts have been calling for Unilever to accelerate earnings and become more aggressive. The cacophony of voices from "the market" seeking to pressure Unilever's management into action seems premised on the misplaced notion that the company has been underachieving. In reality, Unilever has been particularly successful at striking the right balance between present and future needs and ambitions. This has enabled the company to deliver, not only for its shareholders, but also on its broader social purpose. Investors in Unilever's London-listed shares have been rewarded with a return of just under 13% a year over the past decade, versus a little over 5% a year in the FTSE100. Sustained for 10 years, this has meant a 230% return versus 66% in the index.[34]

Meanwhile, through its Sustainable Living Plan, Unilever is strengthening the agricultural practices of 600,000 farmers in its supply chains. It has reduced the water intensity of its factories by nearly 40% and helped to reduce child mortality by educating over 300 million consumers in developing countries to use soap. Constructive partnerships with smallholder farmers have helped to make the company's supply chains more efficient and resilient. Environmental efficiency measures have taken cost out of the business and resulted in margins higher than would otherwise be the case. These very real investments in the business involve Unilever making a choice to defer some of today's profits in order to realise greater gains tomorrow. They cannot be captured properly by spreadsheets and financial models.

Indeed, Unilever's commitment to sustainability seems a particularly popular target for critics keen to point out that the company is failing to allocate resources and time efficiently. This seems to betray a fundamental misunderstanding of the company's history, value system and competitive advantage. Rather than an optional extra, the Sustainable Living Plan is a central tenet of Unilever's identity, aspirations and long-term strategy. The crucial point is that rather than a drain on resources or a distraction for management, sustainability leadership has helped to drive superior investment returns over time.

SO WHAT TO DO ABOUT IT

Asset allocators have a huge role to play in driving vitally needed industry change, be it through selecting investment managers, or the approach to asset allocation. Investors at every step of the investment supply chain should consider the sustainable development challenges outlined above as part of how they manage their clients' capital.

Some first steps include:

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- Get educated – learn about the sustainability issues that are relevant to the long term sustainable development challenge;
- Engage in the dialogue – participate in the Investor Group on Climate Change,[35] the Responsible Investment Association;[36]
- Be brave enough to define risk as the risk of losing money rather than deviation from a benchmark;
- Delve beneath the rhetoric on responsible investing to ensure mangers are truly allocating capital to the most productive parts of society;
- Be a long term investor – For example, put soft company turnover limits on portfolios, develop a balanced scorecard for measuring manager performance (not just benchmarks), and require more transparent reporting by fund managers (including their company engagement);
- Work to improve the transparency and practices of the industry – hidden fees, soft dollar commissions are hopefully a thing of the past, but the investment banking and stockbroking industry still has a way to go;[37] and,
- Remember who we are ultimately here to serve[38] and sign the banking and Finance Oath.[39]

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ENDNOTES

1. Source: Living Planet Report, 2014, http://assets.panda.org/downloads/wwf_lpr2014_low_res.pdf

2. Source: American Diabetes Association, http://www.diabetes.org/advocacy/news-events/cost-of-diabetes.html?referrer=https://www.google.com.sg/, June 2015

3. For more information on "green book keeping" see: http://www.stewartinvestors.com/en/our-funds/sustainable-funds-group/our-articles/green-bookkeeping/

4. Source: https://en.wikipedia.org/wiki/Great_Pacific_garbage_patch

5. Source: World Economic Forum, Ellen MacArthur Foundation & McKinsey & Company, 'The New Plastics Economy – Rethinking the future of plastics', 2016.

6. Norwegian Environment Agency, 'Microplastics', http://www.environment.no/topics/waste/waste-and-recovery/microplastics, June 2015

7. The Guardian, 'Woolworths and Coles to phase out single-use plastic bags', https://www.theguardian.com/environment/2017/jul/14/woolworths-to-phase-out-single-use-plastic-bags-over-12-months, July 2017

8. Reverse Vending Machines are machines that use technology to identify, sort, collect and process used beverage containers.

9. Source: UNEP, 'Valuing Plastics: The Business Case for Measuring, Managing and Disclosing Plastic Use in the Consumer Goods Industry', 2014.

10. For more information on the Plastic Paradox, see: http://www.stewartinvestors.com/en/our-funds/sustainable-funds-group/our-articles/the-plastics-paradox/

11. Source: 'Responsible Investment Benchmark Report 2017 Australia', RIAA, July 2017.

12. Source: 'Responsible Investment Benchmark Report 2017 Australia', RIIA, July 2017.

13. Source: 'Responsible Investment Benchmark Report 2017 Australia', RIAA, July 2017.

14. Source: Hale, J. 'Sustainability Matters: Sustainability and Quality Go Hand in Hand', March 2017. 'Responsible Investment Benchmark Report 2017 Australia', RIIA, July 2017.

15. Source: Clark, G., Feiner, A. & Viehs, M. 'From Stockholder to Stakeholder', September 2014.

16. Source: Clark, G., Feiner, A. & Viehs, M. 'From Stockholder to Stakeholder', September 2014.

17. Source: Eccles, R., Ioannou, I. & Serafeim, G. 'The Impact of Corporate Sustainability on Organisational Processes and Performance', 2013.

18. When using a value-weighted portfolio, the results indicate an annual outperformance of 2.3%.

19. Core responsible investment approaches apply at least one of the following primary strategies: negative, positive or norms-based screening; sustainability themed investing; impact investing, community finance; or corporate engagement.

20. Source: 'Responsible Investment Benchmark Report 2017 Australia', RIAA, July 2017.

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21. The three and five year results are also supported by Lonsec's findings in their Australian and Global Equity Responsible Investment Sector Review for 2017.

22. Source: 'Responsible Investment Benchmark Report 2017 Australia', RIAA, July 2017.

23. Source: Hale, J. 'Sustainability Matters: Sustainability and Quality Go Hand in Hand', March 2017.

24. Source: Hale, J. 'Sustainability Matters: Sustainability and Quality Go Hand in Hand', March 2017.

25. Source: Financial Times, 'Passive Funds grew 4.5 times faster than active in 2016', https://www.ft.com/content/c4f6ee56-e48c-11e6-9645-c9357a75844a, 2017

26. For more on the potential for stranded assets and unburnable carbon see: http://www.carbontracker.org/report/unburnable-carbon-wasted-capital-and-stranded-assets/

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30. Source: SCM Private, 2016.

31. Source: SCM Private, 2016.

32. Source: Lewis, M. 'Flash Boys: A Wall Street Revolt', 2014.

33. Source: Barton, D. Bailey, J. & Zoffer, J. 'Rising to the challenge of short-termism', http://www.fcltglobal.org/docs/default-source/default-document-library/fclt-global-rising-to-the-challenge.pdf, October 2016

34. Source: Bloomberg.

35. For more information, please see: http://www.igcc.org.au/

36. For more information, please see: http://responsibleinvestment.org/

37. For the Stewart Investors approach to unbundling, please see: http://www.stewartinvestors.com/en/research-tenders/

38. Stewart investors has developed its own Hippocratic Oath for such purposes, please see: http://www.stewartinvestors.com/en/stewardship/hippocratic-oath/

39. For more information, please see: http://www.thebfo.org/home

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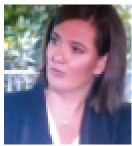

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