WALTER SCOTT

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ESG Commentary

QUARTER ENDING
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Global Commentary

FIRST QUARTER 2019

COMMENTARY

Over the first quarter of the year, the team clocked up 144 meetings with companies in Edinburgh or on the road, with several research trips to the US, an extended trip to Japan and a series of meetings around the Nordic region.

Members of the team also attended the UK Sustainable Investment & Finance Conference, *The Economist's* Sustainability Summit and participated in a roundtable discussion hosted by the UK's Financial Reporting Council (FRC), on its forthcoming update to the UK Stewardship Code. In the words of the FRC, "the UK Stewardship Code has been reshaped to set new and substantially higher expectations for stewardship, with a focus on developing stewardship to deliver sustainable value for beneficiaries, the economy and society". We welcome the steps that the FRC is taking to make the code more stringent. These steps will not require any changes whatsoever to our process, we must simply add detail to our current response to the code. Work is already underway in that regard.

COMMENTARY

The case for ESG scrutiny is all too easily made. In penning this note every quarter there is never a shortage of corporate missteps. Questionable acts not only by companies operating at the edge of corporate norms but also those at the centre of corporate flag waving, exuberant mission statements and airbrushed photographs of CEOs on magazine covers.

If there is a common thread across the issues we have seen this quarter, and indeed more generally, it is culture. Boxes can be ticked, glossy brochures can be printed, awards won but if a corporate culture does not truly support such work and there isn't a belief in these issues in the boardroom, then all the rhetoric and pages of prose should be taken with a very large pinch of salt.

For Boeing, the tragedies involving its 737 Max aircraft have echoes of BP's industrial and environmental disaster in its Macondo Prospect, back in 2010. Reports suggest that an overwhelming competitive need, and management mission, to bring the aircraft, with its new technology, to market quickly was then compounded by budget restraints at the US Federal Aviation Administration. This led to normal testing and verification being delegated to Boeing and then fast tracked by the company. One can certainly question a culture that can apparently permit shortcuts of this nature.

Facebook and Cognizant found themselves in the news this quarter regarding the treatment of content moderators. This would have been a niche role in a news organisation not that many years ago. Cognizant now provides Facebook with thousands of individuals tasked with viewing the worst that humanity has to offer. It will surprise no one that this is an employment market that will continue to grow. To Facebook, this might be considered akin to a tax for doing business. But a myopic "tax" mitigation approach will not work. Facebook has committed to increased pay, but the perceived treatment of moderators has become just as important. This speaks to the integrity of Facebook's operating culture, not only for direct employees but also for contractors provided by companies like Cognizant. Facebook will almost undoubtedly remain under public scrutiny in terms of the working conditions for this army of moderators.

Elsewhere in the technology sector, in its most recent quarterly results announced in March, Alphabet noted a US$1.69 billion fine from the European Commission for anti-competitive practices. This takes Alphabet's tally of EU fines to three, totalling US$8.45 billion and all within the last two years (and all now under appeal). From our perspective, we continue to work on the assumption that Alphabet, and Google specifically, will be the subject of further regulatory scrutiny, fines and attempts to legislate the internet by delegating responsibility.

Addressing ever more regulation is now part of day-to-day business across many sectors, with the recruitment of ever more lawyers. But it is the direction given to those lawyers, and the strategy and approach to these issues that is set in the boardroom, that will ensure long-term sustainable success. Again, culture is key in shaping appropriate and ethical guidance and decision-making.

In our view, management teams cannot simply apply financial metrics to every situation. That is why we believe our investment approach is particularly valid. Our "seven sisters" framework considers quantitative and qualitative factors. The weights attached to those many factors are not predefined. All elements must be considered but the weights will vary company to company. ESG issues are not a box at the end to be ticked, instead they are considered at every stage of the process. There are more and more tools at our disposal to assess ESG metrics and gauge success but judgement still applies. Here, we believe, our collective approach is invaluable.

We look for high margins as a sign of a company with market leadership and a strong competitive position or product. But, more importantly, we look for a sustainable margin structure. Short-termist and excessive cost-cutting is rarely a long-term winner. This brings us back to the importance of culture.

Of course, it is not all fines and discontent. During a research trip to Japan in March, we met with Shin-Etsu Chemical. With an approach to engagement that has always been patient and consistent, it was pleasing to hear that a conversation with us in 2015 was central to its reassessed dividend policy. As part of that trip, we also had a very encouraging meeting with Hoya's newly installed IR manager. Back in 1995, the company was at the vanguard of board change with independent representation. It continues to stand out as a corporate governance role model in Japan.

To add to that evidence of Japanese companies overturning historic characterisations, during a meeting with Fanuc's chief operating officer and head of shareholder relations in our offices in February, we were asked to provide feedback on the company's existing shareholder returns policy ahead of a planned update. Having gathered our collective thoughts, we have put our views down in writing to the company.

Dr Eliza Filby, demographic and generational expert, who spoke at our Investment Conference in Edinburgh last year, co-authored a report on millennial recruitment launched on International Women's Day last month. The context of the report is that, by 2025, the much maligned millennial generation will make up 75% of the workforce. In looking at gender diversity, her study found that gender issues are no longer divided as they were historically. Instead, she argues that all genders are increasingly concerned by the same workplace opportunities and benefits. This again speaks to corporate culture. Dr Filby's report notes the commitment and dedication that this generation will give to an employer with a strong culture based on mutual respect and flexibility, as well as a shared commitment to ambition and growth.

Culture can't be imposed, it can't be dreamt up by a PR firm. But nor can it be analysed or stress tested in a financial model. Instead, we look for a wide variety of flags, good and bad that might indicate a short-term mind set.

We look for behaviours and values that are embedded throughout an organisation. We set great importance in ongoing communication with company executives, as well as divisional heads or regional managers. We believe in reward, but any remuneration structure must be appropriate and transparent. We believe much can be learnt from considering the past; looking at a company's history or a CEO's career record.

It is about as far from AI as it is possible to be, but often, it is the records within our library of company files (actual, physical files for the avoidance of doubt) with meeting notes from the 1980s and 1990s that gives us that extra confidence we need to invest — or the final prompt to walk away.

COMPANY ENGAGEMENT

The Walt Disney Company (Disney)

As we have written about previously, we began to engage with Disney on CEO Bob Iger's compensation plan back in March 2017 and have continued those conversations ever since. In keeping perhaps with the glamour of a movie premiere, or fictional princesses, we considered Mr Iger's compensation package to be not just glitzy, but excessive and not sufficiently aligned with shareholders' best interests.

Having voted 'for' Mr Iger's compensation plan in 2017, we voted 'against' the plan in 2018. Ahead of Disney's AGM on 7 March this year, following extensive discussions with the company and amongst the team at Walter Scott, we decided to vote 'for' the high profile advisory vote, supported by the Disney Board, on Mr Iger's re-worked compensation plan.

Whilst we recognise that remuneration must be appropriate to attract and retain talent, excessive pay is very difficult to warrant. So too, we will always find it difficult to accept a remuneration agreement that is not closely linked to company performance over the long term. In the case of Bob Iger, it had been our opinion that his remuneration package failed on both counts.

Since March 2017, a number of changes, on a number of occasions, have been made to the structure of Mr Iger's compensation agreement. Whilst we had no sympathy with hints from the company that Mr Iger is of such prominence and talent that payment was not as egregious as it may have appeared or that any changes were prohibitively challenging, it was clear that the company had successfully addressed the more extreme elements of the prior agreement.

Following extensive discussion amongst the team ahead of this year's AGM, we agreed to vote in line with management, and in support of Mr Iger's compensation plan, given the steps already taken and the expected direction of travel. That said, in communicating our decision to the company, we made it clear, in writing, that the decision to support the vote this time came with the expectation of further progress.

The decision by the Disney Board just days ahead of the AGM to make further changes to Mr Iger's compensation gave us further confidence in an appropriate direction of travel. No reason was given for that last-minute step, but it seems reasonable to assume the Board felt a successful outcome was in doubt, which in turn speaks to recognition of the importance of this matter.

This is an example of both ongoing engagement and the nature of internal discussions around votes 'for' or 'against' a management recommendation. It also speaks to the need to understand the context of any vote, rather than the bare facts.

Prior engagement can give us a level of trust and confidence in a direction of travel to allow a supportive vote, when a decision based only on the raw facts might not have. Similarly, a vote in favour does not necessarily conclude the matter. In this case, in formally communicating our voting decision to the company we were able to re-iterate concern and make clear our expectation that there would be continued alignment between shareholders and Mr Iger's compensation. In turn, that position will be the basis for ongoing engagement on this contentious subject.

Shin-Etsu Chemical (Shin-Etsu)

During this quarter's research trip to Japan, as noted in the commentary, we had another productive and encouraging meeting with Shin-Etsu, with further evidence that the company's management support a more efficient approach to capital allocation. This shift has not happened overnight and, from our perspective, reflects years of engagement and re-iteration of our views.

At the time of investment back in 1995 and in the subsequent years, Shin-Etsu proved itself to be progressive, in the context of corporate Japan, in terms of its approach to capital allocation with a respectable dividend profile and an appreciation of the difference between a strategically sound cash pile and the hoarding of excessive cash.

However, in the wake of the GFC, Shin-Etsu saw the financial vulnerability of many suppliers and competitors and adopted a much more prudent approach. The company, rightly, undertook cost cutting and its dividend flatlined. In our opinion, in the years that followed sensible prudency turned into a mindset of unfounded caution.

Whilst the business continued to meet our expectations in terms of operating and profit metrics, in our view, its governance around capital allocation was at odds with the best interests of shareholders. The dividend was held flat whilst the cash balance grew.

Having developed a sound relationship with senior management at the company, in 2015 we decided that a change of approach to engagement was required. We arranged a meeting between Shin-Etsu's Chairman Chihiro Kanagawa and our senior management to re-articulate our case for the redistribution of cash through dividends.

Our views have been repeated in numerous meetings since then, in Tokyo and Edinburgh, most recently in March. It is contrary to our self-effacing Scottish roots to acknowledge how gratifying it was to hear the company's Managing Director Toshiya Akimoto refer back to Mr Kanagawa's discussion with Walter Scott's senior management in 2015. Mr Akimoto was clear in the importance he attached to Mr Kanagawa having listened to, and accepted, our case for an increased, and increasing, dividend. Our notes from 2015 refer to Mr Kanagawa's constant refrain "I like cash". We now know his attitude was rather more open.

Tenure on the shareholder register certainly impacts the tone of any meeting with company management. Regular dialogue over so many years affords us the opportunity to not only make views known, but also to re-iterate those views over time.

Of course, it is one thing for us to express views, it is another to determine whether those views have been heard. In Japan, in particular, we believe that our approach, perhaps best described as gentle prodding – consistently and over time – as demonstrated in this case with Shin-Etsu, is both effective and appropriate.

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