WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

ESG COMMENTARY

Quarter ending 31 March 2020

QUARTERLY COMMENTARY

Quarter Ending 31 March 2020

COMMENTARY

For those who have continued to challenge the importance of ESG-considerations within investment, the refrain has often been something along the lines of, "just wait for the next market correction and this fad will be exposed as just that". We have seen that correction this quarter and those critics have remained silent as the actions being taken by companies are viewed through a financial and an ESG lens.

There has been no retreat in expectations around ESG-related efforts. Indeed, the current crisis has highlighted companies that fail to meet what are deemed acceptable standard. The crisis might also visibly separate those companies that merely proclaim commitment to ESG from those whose actions support such claims. From an investment perspective, we continue to engage with companies to assess their approaches and the veracity of headline claims. From a consumer standpoint, there are now a myriad of websites and forums listing 'good' and 'bad' companies, with forgiveness in short supply.

"The challenge for management teams to meet the needs of all stakeholders and uphold sound ESG practices is not to be underestimated"

We often talk of the strength of leadership and corporate culture in the companies that meet our investment criteria. It is in times like now that those strengths come to the fore, and any weakness is exposed. The challenge for management teams to meet the needs of all stakeholders and uphold sound ESG practices is not to be underestimated.

Reminiscent of the US Business Roundtable commitment to stakeholders signed by 181 US CEOs last year, in March the World Economic Forum joined a number of corporate leaders in putting forward stakeholder principles for the Covid era. This was a rallying call to other major corporations to commit to respect safety, partnerships with suppliers and customers, fair pricing and to support societies and governments whilst protecting the long-term viability of the business for shareholders. That, in times of such crisis these initiatives have been broadly supported shows again how far the 'ESG debate' has come.

At a company level, so many have found a way to contribute. L'Oréal quickly switched some factory lines to the production of hand sanitiser. In a call with Reckitt Benckiser in mid-March, management stressed its obligation and commitment to keeping its supply chain open, in particular for its painkiller and antiseptic cleansing brands. Fisher & Paykel has worked to ensure the distribution of its breathing apparatus and US medical device company ResMed has been working with governments around the world to asses needs and deliver ResMed ventilators and other respiratory support equipment. Oracle has been working with the White House on a platform to promote and study the effectiveness of a number of drugs. The diagnostics arm of Roche is also working with US authorities on trials of possible treatments. Adobe is offering its creative cloud services free of charge to aid schools and colleges deliver distance learning. Alphabet has also made significant philanthropic donations whilst also supporting government agencies in a number of ways. Amongst the most prominent is the work of its life sciences research division, Verily, in trying to bring scalable testing for Covid-19. This list goes on.

"As with all ESG issues, it is important to look behind the headline"

That is not to say shareholder returns have been thrown out the window. Instead, there is recognition that long-term financial success depends on consideration of all stakeholders, particularly at a time like this. But, as with all ESG issues, it is important to look behind the headline, assess the context for that individual company and look for evidence of intent beyond mere soundbite. LVMH has been one example of that difficult path. LVMH was one of the first companies to produce hand sanitiser on an industrial scale whilst also producing masks and making significant philanthropic donations. Having received great praise for those efforts it then faced widespread criticism for indications, since withdrawn, that it might tap into public finance in France to pay its employees.

It is also important to look beyond individual initiatives. Alphabet is one example. On a group call, Google's Head of Next-Practice Innovation and Strategy within People

Development spoke of the cultural cohesion that was now evident. In her view, employees - or Googlers in the company's speak - felt the company had in a working and cultural sense returned to its founding principles, which had, in turn, been key in the company's quick reaction. It has also been a significant boost for morale. In time, that should be good for the retention and attraction of the highly skilled resource that the company requires.

Company engagement

Looking across our many company meetings and conversations over the quarter, and putting to one side early discussions around specific actions as result of the current Covid-19 crisis, a number of engagements stand out.

In February, the Inditex stock champion, Alan Lander, travelled to Portugal to meet with one of the company's 1,800-strong global network of suppliers. Having visited factories within the global retail supply chain in both Bangladesh and Vietnam last year[1], Alan was keen to understand the difference between these factories and those that Inditex in particular uses across Iberia and Morocco. For this founder-led business, Polopique, Inditex represents the vast majority of its sales and the companies have grown alongside each other over recent decades. The strength of this partnership has allowed Polopique to invest and align its business with the Inditex business model with its focus on speed-to-market.

"Despite the absence of contracts, it was clear that trust and mutual respect underpins a very successful long-term relationship"

In line with the industry, Inditex operates without purchasing guarantees or commitments. Despite the absence of contracts, in Portugal it was clear that trust and mutual respect underpins what has been a very successful long-term relationship. The description of the factory-retailer relationship in Portugal bore no similarity to the descriptions that had been heard in Bangladesh. Some of that reflects the different services being provided. The former is responsible for huge value-add, with the critical proximity production that allows Inditex brands to respond to changing consumer demand in-season. Fashion-forward, high margin products. The latter is responsible for the basics. Products sourced on industry standard lead-times, with much lower fashion content.

The benefit of this highly efficient and supportive long-term relationship was evident across Polopique's operations and its investment decisions. For example, the factory management described its investment in energy efficiency, with a hydro station on site and solar panels on the roof of its spinning factory that meet 90% of energy needs. They also talked at length about the sourcing of organic cotton and a recent switch from a supplier in India to one in Uganda as part of a need to ensure the integrity of that supply. Polopique's approach to material suppliers is very much one of long-term partnership and trust. Worker pay and conditions was also discussed, with pay typically in excess of Portugal's minimum wage and with health and life insurance on top, as well as annual profit share.

In other noteworthy engagements, we have written previously about ongoing conversations and correspondence with Intuitive Surgical, providing input to its work on a comprehensive approach to ESG reporting. In January, the company published its inaugural sustainability report. We conveyed our compliments on that report, whilst also making some suggestions for the second edition, which have been acknowledge with thanks. We were particularly impressed by the sustainability framework that the company has devised and which it will report on, a framework that covers all stakeholders and some specific programmes alongside more general commitments.

Donaldson is another example of a company with strong ESG credentials, and a commitment to better communication in demonstrating those attributes. . The quality of Donaldson's filtration systems is recognised by customers who, in turn, are becoming more environmentally aware and raising standards. On a call in March, company management mentioned the Blue Sky initiative introduced by the Chinese government as a particular driver of demand. Customers are also increasingly focused on worker safety alongside the

[1] https://www.walterscott.com/standards-at-the-end-of-the-supply-chain/

working environment which, in turn, demands the more robust and technically advanced product that Donaldson can provide. Beyond broad industrial product applications, the company is particularly pleased with its progress in fuel efficiency and electric vehicle filtration. What was also striking is that improved communication is now central to strategy. The company believes it has a good story to tell so have engaged consultants and set up sustainability committees with the aim of strengthening and expanding that narrative. Donaldson now sees the receipt of high ESG ratings and recognition of the company's ESG credentials as central to its investor story.

"We recognise change can take time"

Whilst there have been significant steps forward in corporate governance and ESG integration in Japan in recent years, we recognise that change can take time. That recognition perhaps makes it all the more reassuring when we hear commitment to change come from the most senior management. One of the Research team's final meetings before the Covid-19 restrictions on travel was with Japanese robotic company Fanuc. Over time, we have had many productive meetings with management but ESG has rarely been a particular focus of those conversations. However, our meeting with the President and CEO in mid-February changed that pattern, with management very keen to stress progress particularly on governance. Within Fanuc's board structure, there has been an increase in the number of outside directors, the appointment of an independent outside director to chair the remuneration committee and the appointment of a female board member. Further commitments to increase the number of independent outside directors and to increase female representation have also been made. If you were to consider these steps within the context of global best practice, they might not seem significant but, for us, looking at the path of progression, these steps are reassuring, as was the keenness of management to explain these steps and future plans.

Lastly, a meeting with Mark Schneider, CEO of Nestlé in February stands out as a reminder of the need to ensure that targets are realistic and that inevitable challenges are acknowledged. It was of no surprise that Mr Schneider stressed his wish for Nestlé to be at the forefront of developments in ESG but what added credibility to his ambitious words is the commercial imperative, as he sees it. Although he doesn't think consumers across the board will ever pay for sustainable initiatives, they will demand them and so, in his view, these initiatives will become an important point of competitive differentiation for companies with genuine initiatives in place and that are able to demonstrate actual progress.

"The commitment to change is as important as the outcome at any point in time"

Nestlé is certainly not new to ESG and so Mr Schneider's honest acknowledgment of the challenges faced was an important reminder, if one is needed, that the commitment to change is as important as the outcome at any point in time. He was open in his admission that, across Nestlé's operations, many policies are at an early stage and that, as a company, it needs to be flexible. As an example, he referenced the company's recently announced commitment to use 100% recyclable packaging by 2025. Whilst the target is global, the route to getting there will differ. In Europe, it might be increased use of PET, as there are structures in place for its recycling, whereas in the US it is likely to be achieved through greater use of cans as the US market is better set up for aluminium recycling. He also talked about the benefit of both collaboration and competition. In setting standards, collaboration has been very effective but competition is also an important factor in bringing change. The move away from plastic straws has been driven by consumer demand and the competition to best serve customers. He explained that this led to a land grab of non-plastic straw capacity as companies sought to differentiate their products versus peers with significant investment now going into new capacity. The implication was clear, that the move away from plastic would have been slower if it had come from top-down measures or through a transition agreed by an industry body.

Outlook

The current crisis has become one of both public health and economics. The financial pressures on companies are acute and the job of management teams to navigate the coming months whilst also maintaining high ESG standards is as demanding as it is complex. But adherence to sound ESG practices today is as important as immediate financial and strategic steps in terms of long-term financial success and growth.

> *"Long-term wealth creation by companies depends on many attributes"*

As companies with strong balance sheets and healthy cash generation, take market share or step ahead in innovation and development, so we should also expect to see the benefit of the qualities and strengths we demand show in an ESG context. As with all aspects of our analysis, we will combine qualitative and quantitative research, with conversations with management and judicious engagement. We will continue to seek reassurance that companies are living up to commitments and indeed, furthering those targets.

Progress might not be immediately obvious from ESG ratings. The companies that, over the next few months, proclaim great contributions to society might not be those that are contributing most materially. In uncertain times, it is critical that we combine scrutiny and judgement. Long-term wealth creation by individual companies depends on many attributes, ESG-related responses and actions are certainly among them. This crisis has concluded that debate.

The information provided in this document relating to stock examples should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will feature in any future strategy run by us. Any examples discussed are provided purely to help illustrate our investment style or, are given in the context of the theme being explored. The securities discussed do not represent an entire portfolio and in the aggregate may represent only a small percentage of a portfolio's holdings.

Walter Scott's investment approach: This material contains certain statements based on Walter Scott's experience and expectations about the markets in which it invests its portfolios and about the methods by which it causes its portfolios to be invested in those markets. Those statements are not guarantees of future performance and are subject to many risks, uncertainties and assumptions that are difficult to predict. The information in this schedule is subject to change and Walter Scott has no obligation to revise or update any statement herein for any reason. The opinions expressed are those of Walter Scott and should not be construed as investment advice.

This document is provided for general information only and should not be construed as investment advice or a recommendation. You should consult with your advisor to determine whether any particular investment strategy is appropriate. This information does not represent and must not be construed as an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such an offer or solicitation is unlawful or not authorised.

Walter Scott & Partners Limited (Walter Scott) is an investment management firm authorised and regulated in the United Kingdom by the Financial Conduct Authority in the conduct of investment business. Walter Scott is a non-bank subsidiary of The Bank of New York Mellon Corporation. Walter Scott is responsible for portfolios managed on behalf of pension plans, endowments and similar institutional investors.

Third party sources: Some information contained herein has been obtained from third-party sources that are believed to be reliable but the information has not been independently verified by Walter Scott. Walter Scott makes no representations as to the accuracy or the completeness of such information and has no obligation to revise or update any statement herein for any reason.

Past performance is not a guide to future results and returns may increase or decrease as a result of currency fluctuations. Many factors affect investment performance including changes in market conditions, interest rates, currency fluctuations, exchange rates and in response to other economic, political, or financial developments. Investment return and principal value of an investment will fluctuate, so that when an investment is sold, the amount returned may be less than that originally invested. Portfolio holdings are subject to change at any time without notice.

Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

BNY Mellon Investment Management and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. This is not intended as investment advice but may be deemed a financial promotion under non-US jurisdictions. The information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors.

This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorised by Walter Scott.

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM