

WALTER SCOTT

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Quarterly Report

ESG

Quarter ending 31 December 2019

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Obituaries in the Financial Times and The New York Times for the banker Felix Rohatyn, who died in December, unsurprisingly focused on his role in the financial rescue of New York in the 1970s. But, in contrast to the caricature of an investment banker, these obituaries also make clear that his success over many decades stemmed from enduring relationships, trust and long-term counsel. In the words of Mr Rohatyn, it “must not simply be about making bigger and bigger deals that reap rewards for only a small group of executives”.

The greater the noise, the greater the need to listen carefully

Today, these attributes are talked about, and just as often self-proclaimed, more than ever. Yet, as these obituaries observe, these talents are not common place. Over the past decade or so, alongside the rhetoric of value-add or strategic counsel, corporate culture, ESG and sustainability have become part of every CEO’s script. This is undoubtedly a good thing but, the greater the noise, the greater the need to listen carefully and to separate what can be evidenced from wishful thinking.

Writing in The Wall Street Journal back in 2002, Mr Rohatyn set out his views on corporate governance. Op-eds on governance might be very prevalent today but were not so at the time.

Commenting in the wake of scandals such as Enron and Arthur Anderson he wrote, “in the past few years the most fundamental principles of America’s market system were being flouted: full disclosure, strong corporate governance and strong ethical standards”. Whilst acknowledging the steps that Congress and the SEC had taken, he urged more action. He advocated professionally qualified, full-time independent directors, nominated by large institutional shareholders. He also urged wider acceptance of the UK accounting requirement that required auditors to declare company accounts true and fair, not only in accordance with generally accepted accounting

principles, which he viewed as too flexible. He also challenged the abuse, as he saw it, of stock options that in many cases “failed to align management with shareholders because they eliminated any risk to the holders of the options”. Instead, he suggested simple stock grants, whereby the recipient would be at risk from the outset and where terms would preclude sale until some time after the executive had left the company.

Since 2002, scrutiny of independent directors and the need to demonstrate appropriate skill and diversity has increased markedly. Executive pay is still as contentious as ever but the debate is now much more open and votes at AGMs have begun to show teeth. Back then, who would have imagined that, in 2019, Ginni Rometty, Chair, President and CEO of IBM and Alex Gorsky, Chair & CEO of Johnson & Johnson would corral 179 of their fellow US CEOs to sign a statement under the auspices of the Business Roundtable that would put all stakeholders on a level peg.

Our belief in the importance of ESG factors has been a constant

Over the past few decades, the steps forward in recognition of the importance and value of ESG in an investment context have been remarkable in many ways.

For Walter Scott, a belief in the importance of ESG factors has been a constant. It isn’t rocket science to work on the premise that companies that fail to respect stakeholders or the communities and environment in which they operate hamper their chances of long-term success. We didn’t shout about ESG back in the 2000s – albeit shouting is not our style in any case – but we, like Mr Rohatyn, recognised its value.

What has changed, from our standpoint, is the availability of data and the willingness of companies to engage. As a result, the depth of our ESG research has increased materially. But it is important to stress that, despite that change, ESG research remains wholly integrated. Our analysis and research has one purpose – to build, challenge and test an investment case. All material issues must be considered within that process. This is not box ticking. It is not ‘cookie cutter’. It is

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about assessing all material risks, threats and opportunities, including ESG factors, as they relate to an individual company.

We may now have more data but, very often, particularly in the environmental sphere, verification and comparison remains difficult. Likewise, statements on the social aspects of a company's supply chain often have to be taken on trust. ESG-related research is no different to any other aspect of our research in that, in addition to our own work, the team will speak to experts and comparable peers as well as the company itself. But perhaps more than other areas of research, trust comes into play. Not only must we be confident that the company's stated processes are followed and targets actually achievable but we must also attain a high level of confidence that the culture underpinning those initiatives matches what we are being told. We believe it is important that the same team that engages with a company on its financial results or strategy is central to conversations on ESG. Only through such consistency, knowledge and engagement over long holding periods do we feel that we can make informed judgements. Our integrated, holistic research is as much about the assessment of stated values and words as it is about metrics. With regards ESG or otherwise, our judgements must be backed by our own research, analysis, due diligence and the collective expertise and experience of the team.

ESG Research

Members of the team spent two weeks travelling from Hanoi to Ho Chi Minh City and then to Dhaka

A trip to Vietnam and Bangladesh in the fourth quarter is an example of our in-depth on-the-ground research. Over two weeks members of the team travelled from Hanoi to Ho Chi Minh City and then to Dhaka to examine conditions at one end of the supply chain for many global retailers and apparel brands. Travelling to areas around these cities the itinerary included factory visits, meetings with factory owners, industry groups, trade union leaders and representatives of a number of major retailers working in-country. There was also the

opportunity to speak to workers both in factories and in their homes.

The stench of chemicals might not have gone but clearly marked, and unblocked, fire exits were now evident

For one member of the team, this was a return visit, having undertaken a similar trip to Bangladesh and Myanmar in 2014. That trip was organised in the wake of the Rana Plaza disaster in Bangladesh where over 1,130 were killed and double that were injured in the collapse of a garment factory. Following that disaster, numerous pacts and agreements between global retailers were strengthened and expanded to address working conditions. On this latest trip, there was compelling evidence that conditions have improved. The stench of chemicals might not have gone but clearly marked, and unblocked, fire exits were now evident, by way of example. That is not to say factories meet the standards that the end customer might expect, or imagine, but there was certainly evidence of steps forward. For the workers themselves, however, hope of an improved standard of living that came through in conversations with workers in Bangladesh back in 2014 was notably lacking this time around. The need for long-term contracts with global retailers to allow both factory investment and consistent, even if not higher, pay was cited by both factory owners and workers. In summarising the situation, one factory owner said bluntly, "the retailers are much cleverer than we are". He explained that he negotiates terms with the sales team of a global retailer, and then that retailer's sustainability team arrives on site separately. That team adds requirements, which in turn cost money and require investment, but any attempts to return to the negotiating team are always fruitless. Whilst the work of the sustainability teams working for our high street retailers are evidently working in many ways, the challenges being faced by owners, and their workers - who we witnessed living in slums with little prospect of change, nor education for their children - cannot be ignored. If a reminder was needed that work in this area needs to continue, December brought news of a fire in a Delhi bag factory. According to reports, 43 died and a further 50 were seriously injured. Those who were killed and injured had been sleeping on the factory floor.

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[In Vietnam], a sustainable, social contract appears intact

By contrast, meetings and factory visits in Vietnam were much more encouraging. A sustainable, social contract appears intact whereby the average factory worker is able to earn a living wage through the combination of a minimum wage and overtime, in a working environment that is largely acceptable. In this context, the rise in Vietnam's share of global apparel exports seems appropriate as do decisions by companies including Nike and Adidas to exclude Bangladesh from their primary sourcing strategies.

Company investor days were a prominent feature of the Research team's diary in the fourth quarter. These are carefully choreographed events but there is always something to be learnt from the particular focus and tone, especially when regularly attended over time. These events also often provide the opportunity to meet with lower tiers of management and those responsible for particular areas such as HR, R&D or sustainability. It is conversations like those that add an important element to our holistic research and that establish trust in a company's operating ethos.

At healthcare company, Novo Nordisk's investor day in November, the Head of HR talked about driving a cultural shift that involves more risk taking and "failing fast". Time was also spent recapping on the company's longstanding social programmes, notably accessible medicine and public health initiatives. There will be a step up in such activity in the US next year with an increase in the number of programmes addressing the prevention of diabetes. From Novo's perspective, purpose and sustainability alongside innovation and therapeutic focus allows the company to be clinically differentiated.

The HR department was also front and centre at Adobe's investor day, with the first keynote presentation focused on the workplace environment and the company's high scores across a broad range of rankings and surveys for diversity, and gender equality specifically.

A site tour of one of Edwards Lifesciences facilities in November began in its headquarters. In the atrium of that building, one wall pays homage to the company's founding scientists and executives, another wall

celebrates employees by their length of tenure. Hundreds of employees have been with the company for longer than 20 years. The CEO, Mike Mussallem, is one of many listed with a career at the company spanning more than 40 years. Those statistics say as much, if not more, than awards for employee satisfaction or surveys on staff morale.

In that same atrium, Mr Mussallem hosts quarterly business updates for the circa 4,500 employees of this California campus. As the market leader in the treatment of the heart disease, aortic stenosis, every update includes a patient story, broadcast onto a big screen, which journeys through the illness, procedure and convalescence. Some patients independently reach out to the company. When this happens, the individual is invited to tour the facility and – by tracking the serial number of the valve – that tour will include meeting with those who built the particular implant. A patient-first mantra in action.

Speciality chemicals company, Sika's capital markets day was a reassuring one, with clearly stated growth and sustainability targets to 2023, as well as detail on how these targets are set and the path to meeting them. In terms of scope 1 and 2 emissions, the company is now committed to reduction in the CO₂ intensity per tonne sold by 12% by 2023. Further, scope 3 emissions present a notable opportunity. Amongst the examples cited were the development of concrete admixtures that reduce the amount of concrete required for the same structural strength as well as admixtures with reduced water consumption. As an indication of culture, it was notable that employees from Parex, which was acquired by Sika earlier in the year, were well represented at the event at both senior and junior levels.

Continuing on environmental highlights, a meeting with the CFO of Spirax-Sarco provided a reassuring reminder of its innovative environmental direction. The company is a market leader in steam systems and niche pumps. Steam is used as a heat source in many critical industrial processes such as heating, curing, sterilising and humidifying where there are few alternatives. Steam will often be one of the most material parts of a company's energy budget.

The management of Spirax-Sarco is confident that the company can play an instrumental role in limiting this energy consumption and helping customers such as Nestlé reach net zero emission targets over time.

In just steam, the company believes it saved its customers 5.8 metric tonnes of CO₂. The appeal for its

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customer base is unsurprisingly strong; reducing a company's carbon footprint, not just its cost base. Spirax-Sarco now offers strategic account management around the globe to do just that and management noted particularly interesting growth opportunities in China, with carbon reduction efforts taking off in a meaningful way.

Lastly, a meeting with the CFO of Mastercard touched on data management, amongst the most high profile and contentious of social issues. The scale of the Mastercard network has always been considered a significant barrier to entry. The holistic nature of its service offering (fraud detection, processing, loyalty programmes, marketing amongst numerous other attributes) is also hugely powerful. Thanks to both that scale and breadth, Mastercard has the ability to apply and maintain robust data principles.

Customers own, and have the right to control their own data, and should have the opportunity to benefit from it

During our meeting, the CFO described the non-negotiable set of principles that guide everything that Mastercard does and stands for. To ensure safety and integrity of the network, the company engages heavily with secret services and police departments around the world, abiding by its clearly defined principles that make clear that consumers own, and have the right to control their own data, and should have the opportunity to benefit from it. For Mastercard, its duty is to protect the data. As they continue to enter new lines of business, management believe it's "important to know what [they] stand for" as the implications of data protections and the rules around data continue to evolve and expand.

At the beginning of the quarter, a member of the Research team also attended EOG Resources' inaugural ESG investor event spending a day in the field visiting facilities in the Permian Basin. A review of that trip, titled, Talking ESG in Texas, was distributed in December.

Outlook

Ethics will turn out to be good business (and) will sell at a premium

Felix Rohatyn's 2002 article concluded, "ultimately rules are no substitute for ethics. I believe that the corporate world and the financial markets will ultimately reward ethical behaviour – and (as we are now seeing) punish those who are guilty of questionable practices. Ethics will turn out to be more than a moral imperative; it will turn out to be good business. It will sell at a premium".

That remains as valid a conclusion today as it did in 2002.

Our in-depth, in-house, holistic and integrated ESG research remains, as always, focused on identifying market leaders, building a long-term business case based on financial, strategic and sustainable metrics. Through our research, collective debate, and very importantly, engagement, we work to build the requisite trust and confidence in a company to invest for the long term.

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