WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

ESG COMMENTARY

Quarter ending 30 June 2020

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In an interview at the end of June with a group of European newspapers, Germany's Chancellor Angela Merkel said, *"the coronavirus pandemic is confronting us with a challenge of unprecedented dimensions. It has struck us all indiscriminately. On the one hand, it has torn us away from a period of positive economic development in all EU member states. On the other hand, it has coincided with the two great disruptive phenomena of our time, climate change and the digital revolution, which are changing our lives and our economies regardless of the virus. I am very sharply focused on all of this."*

That the need to address climate change has remained top of the agenda marks an important difference to crises that have gone before.

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>
> *That is no longer the case"*

As Covid-19 continues to plague society, so companies must cope with the economic fallout of this crisis. But it is not only financial targets that companies must meet. In the past, a tough economic environment might have been considered an acceptable excuse to pause on non-financial metrics. Few questioned a financials-come-first approach. That is no longer the case. Indeed, in today's economic crisis, the demands upon companies to address environmental and social issues have grown not diminished. As much as Covid-19 has tested the resilience of companies both financially and operationally so companies must also show action and empathy in regards to employees, contracted staff and suppliers. Tax efficiency is being judged in a new way and efficient outsourcing no longer extends to outsourced responsibilities. Ill-defined or on-the-horizon environmental targets are no longer acceptable. Targets must be well defined, easily tracked and judged. Companies must demonstrate beliefs and behaviour.

Companies are being called out by investors, the media and consumers. In April, UK research on public trust in brands conducted by PR firm Edelman found that 65% of those surveyed said corporate behaviour during the crisis would impact future decisions with 37% saying they had switched brands already because of behaviour over the crisis.

Over the quarter, we've seen scandal at one extreme as well as the more regular attempts to mis-direct. Fraud at Wirecard comes high in the ranking of corporate scandals of all time. But social-washing has also been widely reported upon, and criticised, alongside the still ever-present claims of green-washing. The *Financial Times*, called out German manufacturing company, Schenck Process, in its attempt to present adjusted financial results. Coining a new acronym, the company encouraged investors to focus on adjusted Ebidtac, earnings before interest, tax, depreciation, amortisation and coronavirus. From our standpoint, the need for in-depth, company research continues to grow. Just as we focus on the notes to financial accounts, so we must pay the same attention to information, and omissions, in the appendices and footnotes of sustainability reports.

Environmental standards

If one can point to a positive in this truly horrible pandemic, it is the environment with clear skies and cleaner air. But the positive is not only in the here and now, it is the ever-increasing expectations that companies will act to reduce their environmental footprint in a meaningful way, and will do so soon. Politicians have joined consumers and investors in those louder calls for change. Chancellor Merkel's economic rejuvenation plan, announced in June, includes €2 billion for auto companies to convert factories to produce electric cars, €2.5 billion investment in charging points and battery research and €7 billion for hydrogen initiatives. Also in June, the European Parliament adopted new legislation on sustainable investments to both "prevent green-washing and boost green investment" and "help achieve the goal of a climate-neutral EU". Around the same time, BP announced a £14 billion write down in the value of its oil and gas assets given a more downbeat view on the outlook for oil prices and an expectation that the current pandemic has only quickened a move away from fossil fuels.

In June, we heard from Pierre Etienne Franc, who heads up Air Liquide's hydrogen operations. He spoke at our investment conference in 2016 and is a founding member of the World Hydrogen Council. Hydrogen is at the heart of today's energy transition, presenting a huge opportunity for industrial gas companies like Air Liquide. The World Hydrogen Council estimates that hydrogen could represent 18% of energy demand by 2050, ten times the position today. Eighteen countries have hydrogen in their energy transition policies, representing 70% of world GDP. Hydrogen and CCS (carbon capture and storage) are also key parts of Shell's, BP's and Total's carbon neutral plans.

Social licence to operate

The 'Social' in ESG has also become an imperative. That in June so many of the world's biggest brands, and most prolific advertisers, so quickly signed up to #stophateforprofit and boycotted Facebook was just yet further proof that social credentials are now a crucial part of doing business.

> *"This conversation must not stop at quotas and percentages, workplaces must become multicultural in their practices, structures and communications"*

Throughout the quarter, countless companies have stepped up in terms of their employee engagement and support, not only through pay but also through extended leave, such as implemented by Microsoft, as well as acknowledgement of the challenges of working from home, both physical and mental. The Black Lives Matter movement has also shone an important light on company practices. On a recent webinar hosted by the International Corporate Governance Network, it seemed generally accepted that the same kinds of quotas that were implemented to increase female participation would be required to make any meaningful inroad into black participation. However, the point was also made that this conversation must not stop at quotas and percentages, workplaces must become multicultural in their practices, structures and communications. As long-term investors, it is incumbent on us to ask those 'next step' questions. Targets and numbers are one thing but how are working practices and corporate culture changing, and what steps are being taken to ensure continued improvement to attract, retain, include, motivate and reward talented staff.

Engagement

When considering engagement over the quarter, numerous conversations with IT services company Cognizant over the quarter are worth noting. As the Covid-19 crisis has shown us, you can tell a lot about a company in tough times. Back in April, Cognizant faced an episode that every technology company dreads, a cyber-attack on its systems. That said, such attacks are increasingly unavoidable and the more important question in many ways is how a company responds. We spoke with Cognizant in April when this attack became public and again in May to understand the company's response and its effectiveness.

The aim of ransomware attacks is to block access or steal valuable information rather than cause damage. The threat was straightforward: "give us money or we'll publish data". They had accessed internal data, and were at various stages of expropriating it, but none of the stolen data was commercially sensitive and, having found the 'guilty' misconfigured server, the company was able to act quickly whilst also shutting down all internal systems as a precaution. Client systems were not infiltrated but, again, the immediate step was to inform clients with hundreds of follow up 1-1 calls. A number of clients chose to temporarily disconnect from Cognizant's technology ecosystem and all were provided with the technical information and indications of compromise needed to test their own systems and to strengthen their security protocols. Having acted quickly, directly and by sharing extensive information and guidance, according to the company, feedback from clients has been encouraging and positive. We have also discussed any legal ramifications with the company and been assured that there are no obvious areas of concern from a legal perspective, with no client data loss and minimal business disruption. The company has confirmed that it has not been required to send out any force majeure letters and does not believe the incident significantly impaired any clients' ability to function day-to-day.

Proxy voting

In our engagement ahead of company AGMs and in our voting discussions, board composition and executive pay continue to be prominent themes.

Edwards Lifesciences is one company where our pre-AGM engagement is well established. As in prior years, we had no particular concerns and we voted in line with management on all items. But that does not diminish the value of these calls as a chance to hear from the company, to challenge our thinking and to be assured of the company's practices, and the culture supporting those efforts. We have always viewed the company's board as one with an appropriate mix of skill and experience but, having previously asked the company whether it might be too US-focused, we welcomed the appointment of Ramona Sequeira, a senior executive at Takeda Pharmaceuticals to the board, an addition that was confirmed at the AGM in May.

Our call with L'Oréal ahead of its AGM was similarly uncontentious and its AGM also saw confirmation of a strengthened board, in our view. In addition to a new representative from the controlling shareholder, the Bettencourt family, Ilham Kadri, CEO of Solvay Group was appointed to the board. She has extensive chemical experience having held senior positions within Shell-Basell, UCB-Cytec, Huntsman, Rohm Haas-Dow Chemical and Sealed Air. She has also been very active in encouraging women in science. With these changes, 50% of L'Oréal's board is now independent and 58% female.

Non-executive board appointments were also a prominent feature of Kering's recent AGM, all of which we voted for, in line with management's recommendation. Actor and activist Emma Watson joined the board alongside Tidjane Thaim. Previously, CEO of Credit Suisse Group he was also appointed as an African Union Special Envoy on Covid-19 in April and in 2019 he became a member of the International Olympic Committee. The appointment of Jean Liu, President of Didi Chuxing, the world's largest multi-modal mobile transportation platform and a prominent advocate for women in technology, was also approved at the AGM.

Executive pay at KONE was the subject of much discussion amongst the team ahead of its AGM. Our concerns centred on lack of disclosure on the performance criteria associated with its long-term incentive programme. Contrary to normal practice, performance metrics, targets and maximum award levels are not disclosed. In line with our proxy voting policy, a meeting was convened and the stock champion expressed his view that a vote should be cast in favour, and in line with management. Held in portfolios since 2010, his view was that there had never been any issues with the quantum of pay and that the two representatives of the founding Herlin family - including the Chairman of the Board, Antti Herlin who controls 22% of the company and 62% of the voting rights - on the Audit and Compensation committee are unlikely to permit unwarranted or excessive executive pay. Whilst there was sympathy amongst the group for that view, all agreed that the lack of disclosure remained a concern. So, on this occasion, it was agreed that the vote would be cast in favour of the proposed remuneration policy but that the stock champion would formally write to the company laying out our concerns and making clear that in the absence of clear improvement, future votes will be against.

Outlook

"The pandemic looks likely to prompt not just more discussion but required action"

Like climate change, long-standing conversations around inequality have adopted a more urgent tone as a result of Covid-19. Certainly in the UK many have commented on a move from 'we are in all this together' to anger on divergence in outcome as we emerge from lockdown. Demands that companies consider all stakeholders, not just shareholders, were already being made, but the pandemic looks likely to prompt not just more discussion but required action. In that context, we will certainly be quizzing company management to better understand where they draw the line between acceptable and not, and asking for evidence of culture in action.

Professor Sir Angus Deaton won the Nobel Prize in Economic Science for his work on inequality back in 2015 and he spoke at our investment conference the following year. Looking back at the transcript of his speech, one quote stands out. A quote that of course made sense at the time, but today, perhaps unlike then, forms part of corporate decision-making and conversations around boardroom tables. Amongst many considerations, company boards must look beyond financial metrics and optimum operations and re-consider tax structures, the conditions of workers at the end of the supply chain, the treatment of staff suffering physical or mental ill-health and the provision of a safe and supportive working environment. They must look beyond stark percentages to build inclusive and diverse workplaces. For long-term financial success, those conversations are a prerequisite.

"It is important to make a distinction between good inequality, which comes from successful innovation that benefits everybody, and bad inequality, which comes from rent-seeking and obtaining special favours from government. People are generally happy to see other people do well if it means they will eventually share in those gains. But they are not happy at all when it comes at their expense."

Professor Sir Angus Deaton, Walter Scott Investment Conference, Edinburgh, 2016

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