WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

ESG COMMENTARY

Quarter ending 30 September 2020

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COMMENTARY

In recent years, the starting point for this report has become all too predictable. Good news and bad news. As in previous quarters, the bad, or disappointing news, is that there is no shortage of 'ESG'-related scandals or mishaps to report on across the corporate world. The good news is that the number of ESG sceptics continues to decline. Few now question the importance of ESG considerations within any long-term investment strategy. The better news, perhaps, is that our investment approach continues to demonstrate its worth. An approach grounded in our own in-depth research, with a focus on all material issues that might impact a company over the long term, and investment criteria that are both broad and demanding.

This quarter, the CEOs of Facebook, Alphabet, Amazon and Apple faced Congress as the US government, like others around the world, tries to understand and then address the power and influence of these organisations. September saw the departure of the CEO of Rio Tinto along with other senior executives following the company's decision to destroy 46,000-year-old rock shelters in Western Australia.

"Further reminders of that need for diligent scrutiny"

Elsewhere, retail supply chains have been a longstanding area of research for us and there have been further recent reminders of that need for diligent scrutiny. We saw the publication of an independent report, commissioned by online, fast fashion retailer Boohoo.com, to address claims of illegal practices, in both pay and conditions, at a number of its UK suppliers. In short, the investigation did nothing to improve the company's reputation or draw a line under the serious questions posed. Further afield, H&M announced that it had cut all ties with its cotton supplier in China's Xinjiang region in the face of claims of shocking mistreatment of certain groups.

In recent years, there has been as much celebration of the freedoms enjoyed by 'GIG economy' workers, as there has been concern around the limited rights of this growing cohort. Uber has been one of the companies at the forefront of this dynamic with its drivers often the focus of concern. Uber's CEO stepped into that longstanding debate in August with a new approach. Writing in the *New York Times* he reflected that "since the first Uber trip 10 years ago, one existential question has shadowed the company: do we treat drivers well?" He urged a "third way for GIG workers". For a company often characterised by its robust approach to expansion in cities and combative approach to municipal regulations, this was a strikingly conciliatory message and perhaps marks a new, and more respectful, chapter for GIG workers across industries.

Engagement

"Access has improved as CEOs and CFOs find their diaries freer than ever"

Dialogue with company management, across industries and geographies, has continued this quarter. Albeit, these conversations have taken place from our homes, often into the homes of management. Despite some obvious drawbacks to this type of engagement, in many ways, access has improved as CEOs and CFOs find their diaries freer than ever with travel plans on hold.

Engagement with a large American, enterprise software company during the quarter is a good example of this unintended consequence. Remuneration has long been a contentious issue and so, ahead of the company's AGM, it has become normal practice for us to have a call with the company to put forward our views and listen to management's defence of its position on pay. This year, three members of the board joined that call together with representatives from the company's legal and investor relations teams. Whilst the original agenda was set around executive compensation, we were able to use the opportunity to voice our concerns regarding the significant share repurchase programme that has increased financial gearing at the company. In addition, we made a number of suggestions regarding capital allocation policy and disclosure of progress made towards meeting the company's six operational goals, which are central to its performance-based compensation.

The Covid-19 pandemic has also brought more questions around employee health, safety and welfare to our engagement agenda. During a conversation in August with the CEO of a US medical device company, we were told that employee morale was bolstered by the company's role in supplying much-needed ventilators during the crisis. An employee assistance programme was rolled out globally and efforts have been made to track morale with two separate employee surveys that produced encouraging results. A well-being survey in May suggested that staff felt energised and broadly positive, an impressive result that the CEO attributed to the company's strong purpose and culture.

"Our approach prioritises topics by materiality"

We have always followed an integrated approach to ESG within our research and in our dialogue with companies. We use our time with CEO's to quiz them on material aspects of their business, whatever they may be. We don't limit questions on a company's financials to conversations with a CFO. Questions on strategy are not reserved for the CEO. Nor are questions on ESG reserved for whomever a company puts forward. We have always thought there was tremendous value in our approach, which prioritises topics by materiality rather than organisational categories. That approach is one that is increasingly mirrored by companies. Yes, there are still specific investor events focused on ESG but over the numerous virtual investor days that have taken place this quarter, ESG issues have often been front and centre. Whilst this isn't a new trend, it certainly wouldn't have been the case even a few years ago.

Swiss specialty chemicals company Sika is a recent example. During its capital markets day in September, significant time was devoted to sustainability in terms of both targets and innovation of products with sustainability benefits. Speakers added detail on scope 1 and 2 emissions targets for different periods, with a planned 12% reduction by 2023, 50% reduction by 2030 and net zero by 2050. To address scope 3 emissions, by far the most important and where Sika can make the most difference, the company now targets 70% of its products having a positive sustainable benefit.

Stewardship

"Engagement is a two-way exercise"

Engagement is also, of course, a two-way conversation or exercise. We have written in the past about our work over a number of years with a particularly innovative US medical device company, providing input to its ESG reporting strategy. That dialogue continued this quarter with a call, at the company's request, with its Head of Strategy to discuss refined sustainability reporting. In a similar vein, a call with a US industrial manufacturer in July focused on its work to reformulate its sustainability strategy. Having completed a sustainability survey that the company had sent to a group of investors, we proposed a follow-up call. Taking us up on that offer, we were able to explain how we think about various ESG and sustainability concepts, what we consider to be material for the company, what they should be prioritising in their sustainability strategy and how they should be going about that, in our view. We also discussed some of the frustrations around the requirements of different stakeholders, the inconsistency of some, as well as how we think about rating agencies and what they might prioritise in that time-intensive and ever-expanding area. Beyond sharing views and learning more about the company's sustainability initiatives, we hope that this constructive call will set the tone for future conversations.

In a much more formal setting, we also had the chance to explain to a large European energy company how we approach ESG and where our expectations lie. A member of our Research team was invited to present to the company's board in September as part of its efforts to ensure those at the highest levels fully understand the changing requirements and expectations of investors in regard to ESG.

Another common theme over recent years, as well as this past quarter, has been introductory calls with new Heads of Sustainability as more and more companies bring in specific expertise and address the growing burden of work in this area, in terms of reporting and engagement. In August, we had our first conversation with Oil Search's new EVP of Sustainability and Technology. As part of that introduction we were able to outline our views on transition and what we would like to see from the company in that regard. Our questions on Alaskan pipeline risk and the actual 'clean' credentials of LNG were promptly followed up on. We received data on LNG project end-to-end emission from the company's Climate Change Manager and views from its Alaskan team on the TAPS pipeline, which in their encouraging view, is likely to be the most highly regulated pipeline system in the US and possibly the world.

Research

Last year we began a substantial research assignment into the expansive topic of 'carbon', to consider and challenge our understanding and assumptions around this rapidly evolving area. The project, which we aim to conclude by the end of the year, has involved everyone in the Research team. Over the summer, we had teach-ins and presentations across a range of subjects including carbon storage, electric vehicles, renewables, hydrogen and the circular economy. We have also engaged with a number of oil and gas companies to try to unpick the detail of their respective emission targets. Notes below, from our calls with BP, Shell and Total attempt to summarise our thoughts and conclusions thus far.

In August, we had a call with BP to discuss its emissions targets and energy transition strategy. With its recent announcements, in our view, BP is probably now the most advanced of the European majors in outlining how it intends to evolve its business alongside a transformation of its global energy mix. It is targeting unprecedented levels of production decline over the coming decade, and beyond, which should contribute to falling absolute emissions on a scale that is meaningful in the context of global oil and gas demand. A focus on capital disciple and returns should, however, see the business generate enough cash to pay a healthy dividend whilst aggressively pivoting the portfolio towards clean energy and clean mobility. It is still early days, with no guarantee of success, but it would now be difficult to accuse BP of not taking the issue of climate change seriously.

We also spoke to Shell in August. For a number of years, Shell has been considered by many to be the leader of the pack amongst the European super-majors with respect to its emission targets. It introduced the concept of its Net Carbon Footprint (NCF) intensity measure back in 2017. However, in the last few months, its peers have largely caught up if not over-taken Shell on that basis and the company is now rather vague on how oil and gas production is likely to trend from here. Having embraced a transition strategy, its capital investment plans in the near term look a little light. From our standpoint, it will be interesting to see if the company makes any further announcements in the months ahead to advance its position. There is certainly a question as to whether a clean energy arms race is in the offing.

To add to this picture, in September, we spoke to Total with respect to its plans to cut emissions. Its targets appear well constructed and wide in their scope. Total has taken a broad definition of scope 3 emissions and is committing to internalise those scope 3 emissions on oil and gas products still sold in Europe come 2050. However, with the absolute emissions target focused on Europe and with no interim targets, the overall trajectory of absolute emissions for the group is opaque, particularly in the absence of an expectation for meaningful production decline. With regards to transition investments, in our view, Total is probably further ahead than any of the super-majors to date and, looking forward, its ambitions appear similar to its European peers.

Integrating ESG

Beyond research sessions related to our carbon project, the team has also invited external experts to give sessions on accounting standards and stewardship over the quarter. Both topics have fallen under severe scrutiny and so our training was aimed at ensuring we are alert to red flags and questionable practices. A session on stewardship was led by a specialist ESG consultancy, with its aim to ensure that everyone in the team fully understands what is meant by stewardship as well as its purpose. That ESG consultancy is also working with us to better define and communicate our stewardship activities as well as our governance around ESG. A member of the team also trialled the International Corporate Governance Network's revamped Integrating ESG course and numerous members of the team undertook training and development on specific ESG topics. More formally, our updated response to the Japanese Stewardship Code, reflecting the changes to that code, has been posted on our website alongside this year's annual ESG report.

Outlook

“Expectations upon companies across the spectrum of ESG issues continue to rise”

Our quarterly conclusion, and outlook, is again a familiar one. The expectations upon companies across the spectrum of ESG issues continue to rise. ‘Woke-washing’ has joined ‘green-washing’ as a commonly cited complaint around company purpose statements. Targets don’t necessarily answer a problem either and any company needs to demonstrate a road map alongside any targets, with clear ways to measure progress. Companies also need the culture and the incentive structure to support those steps.

All of this speaks of looking beyond and through glossy ESG brochures and rehearsed company presentations. That is what Walter Scott has always done. Our investment approach narrows the world to a manageable subset, from which we can work to understand each company. A stock champion’s day is structured to afford time to reflect and to have responsibility for everything from proxy voting to assessing targets to quizzing the chief executive. As long-term investors, all material inputs or impacts on an investment case must be considered. That approach is now generally accepted, and indeed might now be considered fashionable. For us, it is just what we have always done.

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