WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

*Quarterly Report*

# ESG COMMENTARY

*Quarter ending 31 March 2021*

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# QUARTERLY COMMENTARY

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## COMMENTARY

The arrival of the European Union's Sustainable Finance Disclosure Regulation (SFDR) in March marked the latest step in the evolution of sustainability regulation within the investment industry. Aiming for improved transparency and disclosure among EU financial market participants in respect of how they integrate sustainability risks into their investment process, the regulation hopes to put an end to 'greenwashing', the practice of making unsubstantiated claims about an investment product's environmental credentials. No longer can firms simply claim they *do* sustainability, they must increasingly make clear *how* they do it.

While the UK's departure from the EU means that Walter Scott is not subject to SFDR under UK law, we very much support the new regulations' objectives. We have always put sustainability considerations at the heart of our investment process (whilst perhaps not always articulating the fact as publicly as we might have done), believing as we do that the companies that make the best long-term investments for our clients typically give these matters the attention they deserve.

> "We have always put sustainability considerations at the heart of our investment process"

Of course, it's not just the sustainability claims of financial market participants that are coming under greater scrutiny. The ever-increasing focus on how companies approach their societal and environmental obligations has tempted some to perhaps overstate their attention to these matters or to inflate the extent of any initiatives they have in place. A crucial part of our work is to try and cut through what we are hearing from companies and distinguish between the genuinely consequential and the mere window dressing.

Nowhere is this need for investor discretion more necessary than when assessing a company's response to climate change. Aware of the public opprobrium generated by behaviours that are perceived to egregiously contribute to global warming, many companies are now firmly on the front foot when messaging their climate-friendly credentials. But bold claims around 'net zero' or 'carbon neutrality' must be interrogated rather than taken at face value.

In a little under seven months from now, the 2021 United Nations Climate Change Conference (COP26) will be held in Glasgow, some 40 miles from our offices in Edinburgh. The meeting will be the third time the signatories to the Paris Agreement have met, and the first at which they are expected to commit to enhanced action. The conference is likely to spur even greater scrutiny of corporate attitudes towards the climate, as well as renewed focus in boardrooms as to how best to meet responsibilities.

> "Bold claims around 'net zero' or 'carbon neutrality' must be interrogated"

One company taking an admirable lead in this area is **Unilever**. The fast-moving consumer goods company recently announced its intention to put its Climate Transition Action Plan before shareholders and to seek a non-binding advisory vote on the company's emissions reduction targets and the plans to achieve them. This will be first time a major global company has voluntarily committed to put its climate transition plans before a shareholder vote, a so-called 'Say on Climate'.

Through our membership of Climate Action 100+, we've been engaging with Unilever on this issue and have been hugely impressed by management's commitment to meaningful change. The transition plan aims to achieve net-zero emissions across Unilever's entire supply chain by 2039. It sets out details of how the company will address emissions in its supply chain, as well as how the business will work to decarbonise hard-to-abate parts of its own operations. The plan will be updated every three years and be subject to an advisory shareholder vote on each occasion. Outlining the rationale for Unilever's bold action CEO Alan Jope explained "As governments around the world wake up to the full implications of the climate crisis and start to regulate and price emissions, we are confident that early and ambitious climate action will drive superior performance and create value for all our stakeholders".

Not long after Unilever unveiled its Say on Climate plans, **Nestlé** announced it will ask its shareholders to support its recently published climate roadmap in an advisory vote at this year's AGM. The company has plans in place to cut its greenhouse gas emissions in half by 2030, with the aim of achieving net zero emissions by 2050. This was a welcome announcement for us; we had been engaging with Nestlé on this topic along with other like-minded investors.

Nestlé and Unilever may be ahead of the game in their approach to climate change for now, but we should expect many more to follow in their footsteps over time. In truth, we've already witnessed a marked shift in attitudes in recent years and we are increasingly impressed by the commitment of many companies to reducing their carbon footprints. Boardrooms around the world know that 'box ticking' is no longer acceptable and many seem intent on becoming part of the solution rather than being seen to be part of the problem.

A conversation with **AB InBev's** Head of Sustainability and Head of Smart Agriculture offered an excellent case in point. In our view, the Belgium-based brewer and drinks company has one of the most impressive and proactive sustainability programmes in the food and beverage sector. In 2017, the company committed to achieving five goals by 2025: empowering farmers; improving watersheds; switching to 100% returnable/recycled packaging; obtaining 100% of electricity from renewables; and reducing overall emissions by 25%. While it is yet to announce an explicit ambition to reach net-zero carbon by 2050, AB InBev has set short-term science-based targets that align with the Paris Agreement. Management recognises that initiatives like these are critical to the long-term health of the company and are increasingly keen to share evidence of their work with investors.

"Boardrooms around the world know that 'box ticking' is no longer acceptable"

The largest contributor to AB InBev's overall emissions is packaging. The company is the world's leading purchaser of aluminium cans and glass bottles, so switching to 100% recycled/returnable packaging has the potential to be its most impactful global initiative. However, achieving that goal will require a localised approach. Broadly speaking, efforts in emerging markets will focus on increasing the penetration of returnable/refillable packaging formats, while the company will focus on recycling in most developed markets, where returnable packaging formats remain unpopular and the current infrastructure ill-equipped. The company is also taking steps to reduce the emissions of its distribution network. Unlike some other companies we have spoken with, management is optimistic about the proliferation of electric vehicles in freight and logistics, and is confident that manufacturers will soon be able to overcome some of the challenges related to range, vehicle weight and freight capacity. 800 electric trucks from Nikola and a further 80 vehicles from Tesla have already been pre-ordered.

Unlike many businesses, AB InBev is forced to deal with the real-world consequences of climate change. Indeed, it has identified access to fresh, clean water as its number one business risk. More frequent droughts and rising pollution levels in watersheds pose a challenge to the company's ability to access the water needed to grow ingredients and manufacture its finished products. In response to this threat, it completes a water risk assessment twice a year, which allows it to identify the water sources that are most at risk, plan remediation strategies, and track the health of watersheds over time. Partnerships with local authorities, scientists, and non-profit groups, allow for the protection of healthy watersheds and improvement of those that are ailing. Not only does this benefit AB InBev's operational resilience, but it makes a positive contribution to the communities in which it operates.

As the cases of AB InBev, Unilever and Nestlé show, the world's transition to a low-carbon economy means that any company seeking to deliver long-term growth and sustainably high levels of profitability must have a business model that is relevant in the context of this transition. For long-term investors like ourselves, this has clear implications. It was in this context that the Research Team undertook to revisit the subject of carbon, starting from first principles and endeavouring to build on our collective knowledge of the science, strategies and technologies that will shape the transition to a lower-carbon economy.

Over the course of 18 months, a dozen members of the Research Team looked in detail at individual carbon-related topics, from carbon pricing and oil & gas through to the circular economy and electric vehicles. Findings were shared with the rest of the team through detailed presentations followed by debate and discussion. The results of this extensive body of work can be found here.

One of the most fundamental outputs of this significant body of work is our belief that every company in a Walter Scott portfolio should have relevance in a global energy system compatible with limiting global warming to 1.5°C, the ultimate goal of the 2015 Paris Agreement. In our view, the reference to the "global energy system" is vital. When considering a company's contribution to global warming, we believe it is a mistake to simply consider its direct impact in isolation. Climate change is the result of aggregate system-wide emissions, so we believe that considering a company's impact on system-wide emissions is the most logical way to think about its environmental contribution. A company that is helping to reduce overall emissions can help drive lower increases in global temperatures irrespective of its direct emissions.

"Climate change is the result of aggregate system-wide emissions"

Taking Daikin Industries as an example helps to illustrate this point. Daikin manufactures some of the world's most efficient air conditioning units. If it takes market share, displacing peers who make less efficient units, then there is a benefit for system-wide emissions. Given that air conditioning is a vital human comfort in many parts of the world, with important economic and social benefits, demand will only continue to grow. As such, more efficient units should be incentivised, even if it means that the manufacturer in question might generate more direct emissions.

Of course, our work on this subject will not stop with the publication of this work. As a defining feature of the current and future investment landscape, climate risk will require ongoing investigation and analysis. By continuing to add depth to our understanding of the shift to a lower-carbon world, we can better avoid those companies exposed to significant climate risk, while identifying those with the most to gain from the coming energy transition.

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