WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

ESG COMMENTARY

Quarter ending 31 December 2020

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COMMENTARY

The opening scenes of Coca-Cola's iconic 2020 festive holiday advert take the viewer to an offshore windfarm where the central character works, far apart from his family but for the implicit benefit of us all. More proof, if needed, that environmental and social issues are no longer niche or controversial, and have certainly entered the mainstream. Similarly, throughout 2020 ESG investment issues, and implications, have continued to gain prominence, and acceptance.

With the importance of ESG now recognised and the need for any long-term investor to consider ESG metrics alongside the financial merits of any investment idea now accepted, the question becomes - how should that be done?

In some ways, the task is easier than it has ever been. As investors, we have more information than we have ever had and amongst corporates, there is widespread understanding that they must engage on these subjects. Looking through the records of all the calls between the Research team and companies over the course of 2020, the number that are summarised as an introduction to a newly appointed Head of Sustainability is quite striking. However, standards and rating methodologies remain inconsistent and one of the most common observations, even from newly expanded corporate sustainability and investor relations teams, is lack of resource to respond to every request from every rating agency or industry group, especially as they continue to proliferate. In its third annual status report, TCFD, amongst the most highly regarded of groups in this area, noted impressive steps forward in disclosure amongst signatories but stated "greater disclosure and transparency are urgently needed".

"Determining materiality is critical"

For now, the mass of not-always-comparable data, imprecise statements and difficult to reconcile targets, means judgement is critical. Numbers and statements must be challenged and determining materiality is critical. We believe that this plays to our strengths, our research approach and our experienced team. We must read beyond the headline rating in an ESG rating report. We need to engage with companies to understand their side of the story when it comes to increasingly high-profile social media campaigns or newspaper headlines. As a matter of course, each stock champion must prepare a response to any low MSCI ESG rating and that work is then shared and discussed amongst the team. It rarely leads to any change in view, but the value of our judgement rests on us regularly challenging our research and our assumptions. Legacy legal issues are regularly the explanation for a middling ESG rating, for example. Our investment framework demands that we look at the good and the perhaps not-so-good in a company's history, so as a matter of course we will understand past controversies. But in determining the significance today, we will also want to understand any steps that were taken after that event to prevent repetition. We must also make judgements around trade-offs. Our engagement with CLP over the course of this year in regard to its coal assets is an example of such trade-offs. The environmental case for disposal is clear, but what of the social implications that stem from closing a plant in a rural area where CLP is the only employer of note. There are also government relations to be navigated and where CLP will act, and invest, to mitigate environmental impact what if a potential buyer of these assets has no such concerns or interests. Another example might be Canada National Rail (CNR). On first thought, rail might be placed in a high emission bucket, but every intermodal train removes 300 trucks from the road according to CNR.

The Covid-19 pandemic has also given us the opportunity to challenge our thinking on corporate culture. Very few companies don't claim to care about their employees. In 'normal' times we would assess such statements by looking at employee surveys and employee turnover metrics as well as diversity statistics. We would also consider corporate culture and structure. Is there evidence of a clear governance structure from the board down? Does the evident culture of a company match its rhetoric? Assessing corporate culture is of course very difficult but engagement over the course of 2020 has given us a perhaps unusual, and certainly beneficial, view of corporate behaviour, and culture. We have continued to quiz companies on their treatment of employees, suppliers and other stakeholders in terms of pay and conditions.

"Recognition that employees are tired of the restrictions"

Sometimes there is little that can be done by companies given the restrictions but the tone of the response, and the level of detail at a CEO's fingertips, can be telling. For example, in a call with Viscofan in November, management not only relayed details of a strong set of results but also talked about the pressures upon employees. There was clear recognition that employees are tired of the restrictions and that it is difficult for factory workers wearing a mask for eight hours every day. Management explained that the challenge right now is keeping everyone motivated both on the factory floor and for those working from home. That they recognise the extent of the challenge is a good starting point in ensuring that morale stays high. The change in US presidential leadership also gave us an opportunity to probe management of a major US retailer on employee pay. With federal minimum wages on the agenda of the new administration, the CFO was clear that pay at the company is "way above" the minimum wage in states where minimum wages have been introduced and there is little concern around the possible introduction of a federal minimum wage as this would be "far below" levels in each of the states.

Opportunities

"The very best companies are continuing to invest"

Consumer interest in environmental and social factors is not new, but over the course of this year, attitudes appear to have strengthened. We have all witnessed the micro effects of less environmental pollution and come to appreciate the merits of companies that do the right thing. Beyond cementing a sound reputation and building loyalty today, the very best companies are also continuing to invest. Improved environmental and social credentials are an end in and of themselves, but if not today, they will certainly become a distinct competitive advantage in the future. In the past it was argued that consumers might say they care about environmental and social issues, but that they don't actually take those considerations to the till. Unilever's CEO, Alan Jope recently spoke about this seeming disconnect between what people say they care about and where they decide to spend. He explained that from Unilever's research it remains largely true that Baby Boomers don't care about sustainability. They are however quite up front about that. It is the Generation X'ers that say they care but then don't take those cares into actual spending decisions. Millennials care more but Unilever's research suggests that they care so long as sustainable features don't impact cost, convenience or performance. For Gen Z, however, sustainability is the primary factor in spending decisions, and growth of Unilever's sustainable living brands is now outpacing its others brands.

A conversation with Kering in October covered similar ground. Whilst much of the conversation was devoted to the company's nimble actions in tweaking supply, product and store openings to fit the rolling Covid-19 restrictions around the world, time was also spent discussing continued investment in sustainability initiatives including leather alternatives and second-hand clothing partnerships. As one example, the company has partnered with the private bio-tech company, Bolt Threads, which produces mylo (mushroom leather) that looks and feels exactly the same as real leather. Leather is one of the big elephants in the room within the luxury industry due to its carbon and resource intensive footprint and mylo leather has shown strong growth. It plays excellently into the growing awareness within the industry of sustainability especially among younger luxury consumers.

Outlook

We might all now agree that ESG issues and opportunities are of universal relevance. However, that does not make these issues any easier to resolve. Nor is the pursuit of ESG opportunities an easy option for companies. It requires the same competitive, financial and leadership strengths as the establishment of any other advantage. For us as investors, scrutiny and judgement is more important than ever. What is material to a particular company? What can be proven or compared? How do we judge the ongoing success of very-long targets? Where should we formally engage to drive standards higher or make targets more demanding? Where can we work with others to pursue improvements for the benefit of society, as well as investors? These are all questions that we must ask ourselves every day. That said, with an investment approach that seeks to identify the very best companies around the world, with proven track records and exciting outlooks, we also witness the very best in ESG every day.

"We are fortunate to engage with management teams leading their industries"

Of course, no company is perfect and there is always room for improvement, but we are fortunate to engage with management teams leading their industries in regard to the world's growing environmental issues and social divides. That gives us faith that these issues will be addressed. It also renews our confidence that these companies are doing what they must in order to deliver meaningful, sustainable and long-term growth.

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