WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

RESPONSIBLE INVESTMENT COMMENTARY

Quarter ending 30 June 2021

QUARTERLY COMMENTARY

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COMMENTARY

Back in 2014, HSBC reported that risk and compliance staff now represented almost ten percent of its total workforce and that there were plans to add yet more to that headcount [1]. That statement led to much consternation and comment across the financial media. PWC's announcement this quarter of plans to add 100,000 roles over the next five years to boost its growing and widening ESG practice was met with similar headlines and comment[2]. Then, if any further evidence was needed that corporations around the world would all be held to higher environmental and social standards, the communiqué from the recent G7 summit in the UK was comprehensive in its 'shared agenda for global action to build back better'[3]. The statement that came from the earlier gathering of G7 finance ministers and Central Bank Governors conveyed a similar message supporting a move towards mandatory climate reporting and endorsing the TCFD framework[4].

"This step up in expectations remains a common theme"

This step up in expectations has been evident in our engagement with companies over recent years and remains a common theme. Whilst there is no doubt that these critical issues must be embedded within businesses to then be assessed and improved on, there are still differences between companies in terms of commitment and reporting. There are also still the issues of competing standards, which is presumably where PWC's new recruits will be kept busy.

The frequency of our conversations with companies looking to establish ESG metrics and practicable reporting, working out where best to focus effort and resource continues to increase but engagement with companies looking to reassess and improve upon an existing approach are also becoming commonplace.

One of our conversations during the quarter was with a Japanese chemical company that we have regularly engaged with and that has begun to take steps forward in its governance and sustainability. In our most recent conversation with the company in May, this shift in stance was again attributed to the time that senior management have dedicated to shareholder engagement. One of the messages from those conversations, including with us, was the need for a more streamlined board and changes have now been made. The company has also set up an ESG committee, chaired by the company's President and with input from external parties. As a manufacturing company, decarbonisation is also now rightly high on the agenda. Here we stressed the need for further progress. We will continue to actively engage with the company as we have done over a number years and will specifically press the company for more detail on its environmental strategy in future dialogue and correpondence.

"Through frequent and constructive engagement we have seen that situation improve"

We have also regularly engaged with a US industrial business that is another example of a company that might have previously been considered to be behind in incorporating ESG commitments and reporting into its business model and disclosures, due in part to some understandable scepticism about greenwashing and box ticking. We consider the company to have an admirable corporate culture which has underpinned strong "S" and "G" credentials but disclosure of credentials and ambitions in the "E" arena have, until recently, been limited. Through our frequent and constructive engagement with the company we have seen that situation improve. In recent years we have had numerous discussions with the company, providing feedback on possible approaches and urging meaningful metrics to support robust reporting and measurement. Whilst concrete, and credible, steps have been taken we continue to support the company as it seeks to continue to improve upon its reporting in this area. In our call with the company this quarter we again shared our thoughts on current best practice and peer

[1] https://on.ft.com/3ze3m7I
[2] https://www.reuters.com/business/sustainable-business/pwc-planning-hire-100000-over-five-years-major-esg-push-2021-06-15/
[3] https://www.g7uk.org/wp-content/uploads/2021/06/Carbis-Bay-G7-Summit-Communique-PDF-430KB-25-pages-3.pdf
[4] https://www.gov.uk/government/publications/g7-finance-ministers-meeting-june-2021-communique/g7-finance-ministers-and-central-bank-governors-communique

group comparisons. As in previous conversations, we also stressed that we don't consider ESG as a "separate" or "different" issue to the day-to-day management of opportunity and risk in the business. As a very well run and successful company, in our view, we would expect the management team to continue to address these questions in the way they would approach other business opportunities and challenges. We also appreciate the constant change and competing expectations and standards. In that regard we shared some information and perspective on regulatory changes in Europe and highlighted some companies that we think are addressing these changes well in terms of reporting and disclosure.

"Companies considered pioneers in this area are now reassessing their approach"

But changes in approach to environmental and social issues aren't limited to companies playing catch up. Some of the companies considered pioneers in this area are now reassessing their approach. Over this quarter, we have spoken to a number of companies whose ESG and sustainability plans date back years, if not decades. But those plans are now being revised and restructured. Tougher standards and more defined metrics are being introduced. As PWC has recognised this is now an important business area and profession in its own right and not an off shoot of a marketing or corporate communications department. It requires messaging, certainly, and straightforward communication is perhaps more important, and difficult, than ever, but ESG today is about commitment, investment and innovation throughout organisations.

One of Europe's leading consumer goods companies, with a global footprint in health, hygiene and nutrition, recently reassessed its sustainability roadmap. At a glance, it is arguably less ambitious. But is now more realistic and accountable. Less wishful thinking. The company has also taken parallel steps to ensure these commitments are truly embedded into the culture of the company. Since the 1990s the company's culture has been structured around three pillars - ownership, innovation and delivery. It has more recently added a fourth pillar – care – which not only incorporates the environment but all stakeholders. In speaking about this shift, again, the messaging has evolved. Management are looking to establish volume driven growth on the back of innovative products. The focus on sustainability should support this growth ambition. Management believe that more sustainable products will deliver greater volume growth over time.

"A reminder of the need to constantly improve and innovate"

Investment in products and methods and the pursuit of innovative solutions must be part of any company's response to improvements in environmental and social impact. Another leading European consumer goods company has long been lauded as an ESG leader and a call with its Chief R&D Officer during the quarter was a reminder not only of that leadership but of the need to constantly improve and innovate. It was this humility that struck the stock champion that led this call. With world class R&D, this company has made meaningful steps forward delivering superior and sustainable innovations for competitive advantage but certainly the impression conveyed was of a business that remains humble enough to know there is lots still to to do.

Recent initiatives have included looking again at the chemistry in home care which led to the relaunch of a major laundry detergent brand, now the first plant based cleaning product with 50% recycled packs and the best ever cleaning performance. One of its soap brands is also now the only 100% biodegradable surface disinfectant that is safe for all parts of the home. Looking forward, the creation of carbon neutral ingredients is seen as one of the biggest challenges but one that the company is looking to lead on. Plant based ingredients, dairy free and meat alternatives are a key focus. Recognising this as high growth segement with strong consumer demand, R&D is focused on creating the right taste texture and structure both of which are key.

Unsurprsingly, the company's R&D teams are also focused on packaging, with paper-based solutions a current focus. Sustainable packing was also a topic of discussion on our call with one of the world's most prominent beverage companies in May. From our conversation with other soft drinks companies over recent years, we know that consumer behaviour adds challenging complexity. Consumers want products to eat or drink on the go and they also want to easily dispose of that packaging on the go. Companies have limited control on how products are disposed of.

"Recovery, recycle and re-use"

For this company, plastic remains the biggest issue, or more specifically, plastic waste. Plastic itself is a fantastic material with strong carbon credentials. The challenge is how to deal with plastic waste. How to the close the loop on the plastic system. Recovery, recycle and re-use. The business continues to work with industry groups, NGOs and governments to help to achieve this. The question is one of cost and society's willingness to pay extra for sustainable solutions.

From a technology perspective the company also remains very active. It is focused on introducing more fountain machines and water dispensers. Refillable packaging is one area that has yet to gain any real traction and from the company's perspective without consumer pull it will struggle to generate the momentum needed to overcome the cost and logistics challenges. On packaging more generally, the company is now focused on working with others. Whilst there is in-house technology there is now recognition that solutions are more likely to be developed by specialist partners.

Packaging is also a key issue across the healthcare industry. In May we spoke to a Danish medical device and services company that has long demonstrated its commitment to sustainable practices but that continues to raise its own expectations. In a call with its sustainability team, there was reiteration of a commitment to sustainable leadership, in terms of its users and the company's own needs. As a manufacturer of medical products made of plastics it must address the resultant environmental issues but product safety and clinical performance can't be compromised. Single use products are the easiest and, importantly, safest option for users. In that context, the company is working on waste management and recycling as well as packaging in order to reduce emissions. The company has many legacy products where packaging can be improved including using renewable or recycled materials and it is now redesigning products wherever possible.

Outlook

As PWC put it in a June report, "Are you ready for the ESG revolution?" [5]. Noting that 90% of S&P 500 companies published sustainability reports in 2019, this isn't the advent of ESG. This is the point at which companies must demonstrate change and improvement through evidence and data. There must be clear roadmaps towards commitments, investment in the technology needed to achieve change and accountability within management.

Our conversations with companies have shifted. It is not just about risk avoidance for businesses. Companies now recognise that sustainability must be a key pillar of any successful long-term growth strategy.

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[5] https://www.pwc.com/gx/en/issues/esg/esg-revolution.html

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