WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

Quarterly Report

RESPONSIBLE INVESTMENT COMMENTARY

Quarter ending 30 September 2021

QUARTERLY COMMENTARY

Quarter Ending 30 September 2021

COMMENTARY

Having been signatories to the original UK Stewardship Code in 2012, we were delighted to learn in September that we had been accepted as a signatory to the updated 2020 Code. While the purpose of the Code remains in essence the same – to demonstrate how we hold companies to account on behalf of our clients – the demands of the 2020 iteration are significantly greater, reflecting how expectations in this area have evolved in recent years. Simply having stewardship policies in place is no longer sufficient, instead asset managers must be able to properly evidence actions and outcomes.

Our acceptance as a signatory is not a case of "job done", however. The UK Financial Reporting Council (FRC) has made it clear that to remain signatories, organisations will need to "continue to improve their reporting as market practice and expectations evolve". We support the FRC in this approach and remain committed to the ongoing enhancement of our stewardship efforts.

Indeed, continuous improvement has become something of a theme across all aspects of sustainability in recent years. Whether cutting carbon emissions, limiting resource waste, or addressing challenges around diversity and inclusion, resting on one's laurels wins few plaudits. Stakeholders want and expect progress.

Reflecting this, monitoring of a company's progress on its material sustainability factors is integral to our ongoing analysis. And while we're pragmatic enough to understand that progress on such matters will not always be linear, we do expect management teams to be able to demonstrate a level of resolve commensurate with the severity of the challenge faced.

"Continuous improvement has become something of a theme across all aspects of sustainability in recent years"

In that regard, we have recently spent some time focused on global apparel retailer **Inditex's** efforts to transition to a more sustainable sourcing model and have been impressed by senior management's commitment to the process. The sustainability practices of the 'fast fashion' industry are rightly coming under increased scrutiny, but Inditex, the owner of the Zara, Pull & Bear and Massimo Dutti brands among others, is in the vanguard of change, and a call with the Executive Chairman Pablo Isla during the quarter was an opportunity to discuss current progress.

What came across very clearly during our conversation was Mr Isla's confidence that Inditex's sustainability credentials are increasingly resonating with customers. While customers may not yet be making purchasing decisions solely on grounds of sustainability, the company's sustainable 'Join Life' label is gaining significant traction and is expected to account for 50% of all Inditex garments by 2022. Recent initiatives include the release of a new 100% recycled material Join Life athleisure range. Mr Isla believes that some form of regulation around sustainability labelling is inevitable and that the company's current good standing with regulators and ratings agencies means it is well placed to capitalise should this come to pass.

"Inditex is in the vanguard of change"

The biggest sustainability risks for Inditex lie in its supply chain, however. Labour practices, carbon emissions and raw material use all pose major challenges and initiating positive change can be difficult given such issues are often beyond management's control. Encouragingly, this is not stopping the company taking steps to address these matters. A comprehensive supplier code of conduct is constantly updated and rigorously audited, and the business works closely with suppliers to promote positive changes to procedures and processes. Mr Isla predicts this interaction will play a major role in enabling Inditex to achieve its ambition to be net zero by 2040. While this is a laudable goal and one which we welcome, it is important that we continue to engage with the business to establish greater detail and clarity around how it plans to deliver on its commitment.

Another company refusing to stand still in its sustainability journey is **Texas Instruments (TI)**, the world's dominant player in the production of analogue semiconductors. TI has a long list of sustainability 'firsts': it was the first semiconductor manufacturer to achieve a gold LEED (Leadership in Energy and Environmental Design) rating for its fabrication plants and the first to remove halogen and toxic contents from its chips. It was publishing its Corporate Citizenship report long before such matters became a mainstream industry concern, and despite now being a bigger business its carbon emissions are lower than they were in 2005.

“Texas Instruments has a long list of sustainability firsts”

Despite the considerable strides it has already made, TI is showing no signs of complacency. On a call in August, management highlighted some of the many measures it has in place to help the company build on its impressive track record. In any given year, TI has around 200 energy efficiency projects underway. While many of these are as simple as switching to LED lighting, the cumulative impact is significant; since 2010, per-chip greenhouse gas emissions have fallen by 46%. Under the auspices of the World Semiconductor Council, the company has also joined an industry group focused on the introduction of science-based targets for carbon emissions and reducing the use of a variety of gases.

A meeting with **Alphabet**, meanwhile, gave us a good insight into how the company is tackling the sensitive topic of content moderation on YouTube. Alphabet’s attitude towards its perceived social responsibilities has been the subject of some criticism in recent years but there is evidence that this is changing. The company wants YouTube users to enjoy a positive experience and understands that a negative experience is just one click away. Reflecting this, any content that violates Alphabet’s code of conduct will be removed, while there are also measures in place to limit the spread of content considered ‘borderline’.

Moderating a platform with some two billion users is no easy task, but with the help of AI and machine learning the ability to successfully root out unwelcome content is growing. Last quarter alone, nine million videos were removed. Even more impressive is the improvement in the user experience. In 2017, 70% of users were exposed to what the company defines as “harmful content”. Now that figure stands at a mere 0.02%. It’s not all stick and no carrot, however; users who post positive and trusted content are rewarded with increased reach.

“Last quarter alone, nine million videos were removed (from YouTube)”

Underlying all the examples given above is a commitment from leadership to implementing change that puts each business on a more sustainable footing and, by extension, protects the interests of shareholders. Progress on such matters may often be measured and incremental but it ultimately enhances rather than hinders a company’s long-term prospects.

As Scotland prepares to host the 2021 United Nations Climate Change Conference (COP26) later in October, the world is expecting to see policymakers secure further progress on the transition to a cleaner, more sustainable economic model. Many observers will be hoping for ‘big bang’ headlines and ‘moon shot’ pledges. From our perspective, what is most required is clear, achievable, and binding regulation: it is for governments to set and enforce the parameters of the transition. A coherent and enforceable regulatory framework that provides companies with a roadmap by which to navigate is essential if they are to contribute effectively to the journey to a carbon-neutral world. The accumulated impact of innumerable adjustments to manufacturing processes, supply chain reforms, and shifts in corporate behaviour will play a powerful role in limiting the rise in global temperatures. We will continue to leverage our influence as long-term stewards of our clients’ assets to hold management teams to account, support progress in this important endeavour, and protect the long-term interests of shareholders.

Walter Scott's investment approach: This material contains certain statements based on Walter Scott's experience and expectations about the markets in which it invests its portfolios and about the methods by which it causes its portfolios to be invested in those markets. Those statements are not guarantees of future performance and are subject to many risks, uncertainties and assumptions that are difficult to predict. The information in this schedule is subject to change and Walter Scott has no obligation to revise or update any statement herein for any reason. The opinions expressed are those of Walter Scott and should not be construed as investment advice.

This document is provided for general information only and should not be construed as investment advice or a recommendation. You should consult with your advisor to determine whether any particular investment strategy is appropriate. This information does not represent and must not be construed as an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such an offer or solicitation is unlawful or not authorised.

Walter Scott & Partners Limited (Walter Scott) is an investment management firm authorised and regulated in the United Kingdom by the Financial Conduct Authority in the conduct of investment business. Walter Scott is a non-bank subsidiary of The Bank of New York Mellon Corporation. Walter Scott is responsible for portfolios managed on behalf of pension plans, endowments and similar institutional investors.

Third party sources: Some information contained herein has been obtained from third-party sources that are believed to be reliable but the information has not been independently verified by Walter Scott. Walter Scott makes no representations as to the accuracy or the completeness of such information and has no obligation to revise or update any statement herein for any reason.

Past performance is not a guide to future results and returns may increase or decrease as a result of currency fluctuations. Many factors affect investment performance including changes in market conditions, interest rates, currency fluctuations, exchange rates and in response to other economic, political, or financial developments. Investment return and principal value of an investment will fluctuate, so that when an investment is sold, the amount returned may be less than that originally invested. Portfolio holdings are subject to change at any time without notice.

Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

BNY Mellon Investment Management and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. This is not intended as investment advice but may be deemed a financial promotion under non-US jurisdictions. The information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors.

This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorised by Walter Scott.

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM