WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

QUARTERLY COMMENTARY

RESPONSIBLE INVESTMENT

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COMMENTARY

When Elon Musk tweets (which is remarkably often for a busy man), he tends to provoke a passionate response from followers and media alike. So, when the Tesla boss opined in June of this year that "*ESG is a scam. It has been weaponized by phony social justice warriors*" there was a predictable outpouring of both acclaim and disapproval. While one suspects that much of Mr Musk's Twitter output is crafted deliberately to elicit this kind of fevered reaction, it speaks to the growing polarisation around ESG that it can generate such heated debate.

For many of those in agreement with Mr Musk, ESG has been hijacked by zealots prioritising a narrow social and political agenda over shareholder returns. It's a belief shared by certain US lawmakers, who have warned recently that ESG investing is a potential violation of a state pension board's fiduciary duty. Having progressed relatively unimpeded into the investment mainstream in recent years, it appears ESG is facing its first concerted backlash.

Perhaps not a bad time then to revisit our approach to matters ESG (or sustainability as we prefer to call it). Not, we should point out, with a view to "taking sides" in this increasingly fraught debate but rather with the intention of reiterating the fundamentals of our approach and articulating its philosophical underpinnings. In other words, how we do sustainability and why.

To answer the second part of that question first, the reason we take account of material sustainability considerations is simply because we believe it to be in the best interest of our clients. We analyse these factors to assess their likely impact on our attempts to achieve our clients' long-term investment objective. We say this not with the zeal of the recently converted; since Walter Scott was founded, we've held firm to the belief that the companies that make the best long-term investments for our clients typically adhere to high standards of conduct across all facets of their business.

A company with poor sustainability practices is exposing itself to potential risks and it would be remiss of us as stewards of our clients' capital were we not to measure and assess these alongside other more "traditional" investment considerations. They do not, however, take precedence and we impose no "red lines" or hurdle rates on companies – no company or sector is explicitly or implicitly off limits. Sustainability risk constitutes just one part of a holistic appraisal of the overall risks involved in an investment. As the FT's esteemed *Unhedged*[1] column put it recently, such an approach to sustainability is "just plain old investing, that is, the pursuit of the best possible risk-adjusted returns."

While "plain old investing" may not find many takers as a marketing strapline, it resonates with those of us who have been addressing sustainability considerations as part of our day-to-day research and analysis for many years. Reading through Walter Scott's annual ESG review from 2015, we noted the similarity with today in tone and approach. There has been evolution of course, necessitated by greater client interest, increased regulatory demands around disclosure, and greater availability of relevant information, but the underlying principles of how the Research team thinks about and analyses sustainability have remained the same – practical, rigorous, common-sensical and rooted in constructive engagement.

> *"To some extent, despite the changing demands and the notable increase in available data and information, Walter Scott's approach remains unchanged."*

Walter Scott ESG Annual Review 2015

We would say the same today. Whereas we now have better access to ever greater amounts of information, and while the business and investment landscape continues to evolve, the fundamentals of what we are trying to do, and the core of our analysis are the same. Regularly meeting company management teams and digging into those sustainability issues identified as material to the investment case remains integral to our investment process. Our expectation that companies adhere to best practice likewise. The focus of our dialogue with companies has, however, shifted over time. The factors that will dictate a company's future success evolve and we adapt accordingly.

Historically, most of our conversations with companies centred solely on governance (many still do). Discussions around social and environmental issues, while certainly not uncommon, were rather less frequent. But as these topics have moved further up the agenda of investors, management teams and the public, they become more material and merit greater focus than was previously the case. In truth, experience tells us that these factors are often linked, with poor governance driving poor social and environmental standards.

2015 was a year of high-profile corporate impropriety. In Europe, 'Emissionsgate' was blowing a hole in Volkswagen's reputation, while in Japan, Toshiba was embroiled in an accounting scandal. In Canada meanwhile, pharmaceutical company Valeant, the darling of many an investment portfolio, was unravelling in the face of fraud and price gouging allegations. To us, this litany of misdemeanours simply reaffirmed the vital importance of corporate governance and the central role of senior management in setting the cultural tone of an organisation.

> *"As we know, the structures, attitudes, and messages coming from top-level management have a profound effect on the entirety of a business. Unfortunately, for a number of companies the required consistency of message and internal governance is not present, resulting in a very negative impact on the business."*
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> Walter Scott ESG Annual Review 2015

More often than not, the myth of the "rogue" employee circumventing policy and process under senior management's radar is just that – a myth. The corporate fish tends to rot from the head down. Ultimately, there is no shortcut to building and maintaining an appropriate culture of conduct and governance. It demands constant diligence and strictly adhered to policies and practices. It also asks ongoing vigilance from investors, and engagement remains the most effective means of holding management to account.

This summer, we met with the President of Global Health & Sustainability and the Chief Ethics, Risk & Compliance Officer from Novartis to discuss governance and company culture. Seven years ago, the Swiss pharmaceutical giant's reputation had been tarnished by a build-up of legal proceedings and investigations, some of which pointed to serious failings of ethical conduct. Litigation might be notoriously common in the pharmaceutical industry, but Novartis had become something of a serial litigant. Since then, the company has worked hard to rebuild trust, latterly under the guidance of CEO Vasant Narasimhan. Today, the message from the top is now unambiguous – Novartis should never forgo ethics or compliance to reach its goals. Over the long term, this can only benefit shareholders.

By engaging with Novartis throughout this multi-year improvement process, we were able to not only offer support but also to question and challenge, reassuring ourselves that warm words were translating into concrete action. This latter point is important. Trust might be a

vital ingredient of the management-investor relationship, but this does not mean that the latter should not interrogate claims made by the former – 'greenwashing' may be a relatively new term, but it is not a new phenomenon.

> *"Consideration and indeed positive action in relation to ESG issues is generally to be welcomed. However, in a number of cases a degree of scepticism can be useful and may just scratch off a carefully applied veneer to expose a variety of different underlying motives."*
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> Walter Scott ESG Annual Review 2015

This need for a sceptical eye is especially true in relation to climate change and carbon. 2015 was the year of the Paris Agreement, with its goal of limiting global warming to 1.5°C above pre-industrial levels. Since then, bold claims of decarbonisation and ambitious net-zero strategies have become commonplace, although it is fair to say that not all stand up to scrutiny. What isn't in doubt, however, is that post-Paris, climate change and carbon have moved to the forefront of the sustainability debate. Changing regulation, increased government commitments, and growing consumer awareness mean that these issues have material long-term financial implications for companies and investors alike.

The drive towards decarbonisation is a trend that is reshaping the global economy, so how should we, as investors, respond to this fundamental change to best serve the interests of our clients? With pragmatism, we would suggest. Lamenting the polarisation of the climate debate in our most recent Journal, Alan Lander, Co-Head of Research, spoke of the importance of acknowledging the "complexity and challenge" of the energy transition and of understanding that "short-term needs must be addressed alongside long-term ambitions."

Nowhere is this nuance needed more than in the debate around fossil fuels. The clamour for divestment from oil & gas producers among some sections of the debate ignores in our view the reality of the global energy landscape. It is an unavoidable fact that in the short-to-medium term the world still needs fossil fuels. Indeed, fossil fuels will help us more efficiently decarbonise the global energy system. Gas, for example, is a natural transition fuel – producing 60% less carbon per unit of generated energy when burnt relative to coal. And yet as a fossil fuel it is deemed by many to be an unalloyed bad (witness the European Investment Bank's refusal to fund gas projects). Such rigid thinking risks making the perfect the enemy of the good.

In this context, we think it right to continue analysing the investment potential of 'traditional' energy companies while narrowing that opportunity set to those with commercially credible transition strategies. Only those companies relevant to the global energy transition will be capable of delivering the long-term growth and sustainably high levels of profitability that we seek.

Reflecting on our traditional energy exposure in the wake of the Paris Agreement, we reaffirmed our conviction in our existing energy holdings, noting that the companies *"have a market leading position courtesy of a particular niche, expertise or asset base"*. At the same time, we commended their efforts to *"improve both efficiency and lessen their environmental footprint"*. No mention of the energy transition certainly but the seeds of today's better-defined message are there – to be considered an investment candidate for our clients' capital a company must successfully marry the near-term requirement for fossil fuels with the long-term ambition of decarbonisation. We think this pragmatic response to a complex and

evolving question remains the approach that best serves our clients' interests. Less scam, more plain old investing.

Source

[1] https://www.ft.com/content/7a90ca3b-c9e5-4709-a9ed-edcb1c51b374

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