WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

QUARTERLY COMMENTARY

STEWARDSHIP

Ending 31 March 2023

FOR USE BY INSTITUTIONAL INVESTORS ONLY. NOT FOR USE WITH GENERAL PUBLIC.

COMMENTARY

"For every action in nature, there is an equal and opposite reaction"
Newton's Third Law of Motion

If 2022 was the year that ESG-scepticism found its voice, then 2023 may come to be seen as the beginning of the 'backlash against the ESG backlash'. In the last three months, several US states have witnessed pushback against so-called 'anti-ESG' legislation. In Kentucky, the trustees of a US$20 billion public employee retirement scheme penned a letter to the state treasurer signalling their refusal to divest from a list of financial institutions deemed to be boycotting energy companies. A couple of hundred miles north in Indiana, another public retirement scheme warned that the same approach could potentially harm investment returns, whilst North Dakota's House of Representatives voted 90-3 against similar legislation.

It would be wrong to see this resistance to mandated ESG-related boycotts as a further hardening of the shareholder versus stakeholder capitalism debate. Rather than being couched in the language of ESG advocacy, the objections raised have focused on fiduciary duty. By barring access to a given group of financial institutions, the legislation, it is argued, violates the fiduciary duties of those tasked with acting with due care, skill and diligence.

This renewed debate around the purpose of ESG, and whether the concept is consistent with fiduciary duty is something we consider in our Annual Sustainability Report, which will be published later this month (spoiler alert: suitably defined and executed it is in our view an essential part of our fiduciary duties). We have plenty to say on this point in the report but suffice to say we believe that with respect to running a successful long-term business, delivering for your customers, fostering good stakeholder relations, and supporting and developing your people is the most assured (and perhaps only) route to enduring profitability over generations.

For this reason, we believe the ongoing debate about shareholder versus stakeholder capitalism is something of a distraction, and that there is no inherent conflict between managing a business responsibly on one hand, and for shareholder return on the other.
However, industry confusion still abounds on these points, and the relevant terminology is used in a range of different ways, sometimes creating contradictions and complexity. It is therefore understandable but nevertheless unfortunate that ESG has become a politically contested construct at a time when all businesses are confronting a growing list of social and environmental risks and opportunities.

"We believe the ongoing debate about shareholder versus stakeholder capitalism is something of a distraction."

At Walter Scott, we have observed this debate with both interest and consternation. In our view, the root cause of the problem is the merging and subsequent conflation of two distinct concepts with different goals: the integration of financially material ESG considerations into investment research and asset allocation, with a view to making better long-term investment decisions on one hand, and values-led ethical investment practices on the other.

Both are eminently laudable activities, but at Walter Scott we believe that there needs to be 'clear blue water' between the two approaches, which have markedly different objectives. We define ESG integration in a straightforward way that in our view is entirely consistent with our fiduciary duties – it is about understanding all financially material risks and opportunities pertaining to our clients' portfolios and factoring these insights into our investment decision-

making process. It is therefore something that we do by default for all our clients. We would consider our research incomplete without this information, which could impair our ability to deliver our stated investment objective to clients.

For those clients with additional 'sustainability focused' objectives, such as EU SFDR 'Article 8' type funds[1], we can offer variants of our core portfolios that in addition to our integrated ESG research have been subjected to rigorous additional stakeholder governance and sustainability analysis to determine the suitability of holdings. We call these our 'Additional Objectives Portfolios'. Whilst this nomenclature may be less inspiring than many of the more imaginative industry alternatives for sustainable investment funds, it is clear and consistent with our process.

"We define ESG integration in a straightforward way that in our view is entirely consistent with our fiduciary duties."

For the avoidance of any doubt, these 'Additional Objectives Portfolios' are strictly 'opt in' and the additional methodology has been developed to meet the needs of those specific clients – we would never apply a 'values overlay' on the portfolios of clients who have not requested it or who do not support such an approach.

Despite the ever-shifting veneer of terminology, there is nothing new about ESG integration at Walter Scott. Our business was founded 40 years ago with the firm conviction of being a long-term active owner of great companies on behalf of clients, and this core investment philosophy continues to serve us well to this day. Long before the acronym came into the daily vernacular of the investment industry, we were committed to integrating material ESG factors into stock selection and ownership.

Equally, there has always been a strong commitment to ongoing engagement with management teams, and thoughtful voting at company meetings, and as ever the Research team was busy with both throughout the first quarter of 2023.

One prominent benefit of being a long-term investor is the opportunity to build a level of trust and understanding with management teams that supports genuinely open and constructive engagement over many years. This has proved particularly fruitful around ESG, where many companies in the early stages of incorporating ESG into their business strategies have sought our views on issues such as best practice and materiality.

"In the best tradition of the American Midwest, Fastenal is a business founded on pride, humility, long tenure, and innovation."

Once such company is **Fastenal**, the Minnesota-based distributor of industrial supplies to manufacturing and construction firms in North America. We've been meeting Fastenal regularly since the early 1990s (most recently, two members of the Research team enjoyed a visit to the company's headquarters in Winona, Minnesota in December).

[1] Under the European Union's Sustainable Finance Disclosure Regulation, an Article 8 Fund is defined as "a Fund which promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices."

In the best tradition of the American Midwest, Fastenal is a business founded on pride, humility, long tenure, and innovation. In many ways, however, Fastenal's modest culture risked concealing its excellent values and intentions, and we have long been of the view that there was scope for improvement on matters of sustainability disclosure. Reflecting those concerns, we have been encouraging Fastenal to do more on sustainability related initiatives and disclosures for several years. And whilst initially hesitant, management has been markedly more receptive in recent years, proactively seeking our views on what the business could do better, what progress might look like and the potential impact of regulatory developments. Reflecting the evolution of its approach to ESG, Fastenal now has dedicated sustainability resource in place and is developing a cohesive ESG strategy. Recent initiatives include reporting to CDP and conducting a first ESG materiality assessment, to which we were invited to contribute. The culmination of this work to date was the publication of the company's inaugural ESG report in January 2023.

Announcing the report's release, CEO Dan Florness spoke of Fastenal's growth goals having a "natural alignment" with the "ESG priorities of our stakeholders". The company's strategy going forward will be centred on "reducing resource consumption in our customers' supply chain". Pleasingly, this was something we had discussed previously with management and proposed as an area of focus. In our view, if Fastenal didn't exist, or weren't as efficient, then customers would have to hold considerably more inventory, with the associated impact on resource consumption and waste. We wrote to Mr. Florness and Fastenal's CFO to compliment them on the content and tone of the report. In thanking us for their support, Fastenal pointed to the report as an excellent example of what can be achieved when like-minded parties collaborate.

Another business we have engaged with extensively on ESG issues in recent years is **Intuitive Surgical**, the manufacturer of minimally invasive robotic surgery systems. In March 2021, we initiated an engagement for change with Intuitive aimed at encouraging improved carbon disclosure. Since then, the business has made incremental steps towards aligning its external reporting with recognised disclosure standards, working to ensure that the relevant information was appropriately scoped, and that the disclosure methodology developed could be sustainably reported alongside other standards, such as those published by TCFD and SASB.

"Deft handling of a range of ESG challenges and opportunities is becoming increasingly financially material."

Having participated in Intuitive's ESG materiality survey in December last year, we were able to successfully close our engagement for change in February when the company published its inaugural sustainability report, which included validated scope 1 and 2 GHG emissions and an inventory for scope 3 (in the process of validation).

Both Intuitive and Fastenal are examples of the benefits of what can be achieved in relation to ESG matters through focused and patient engagement. We have a number of engagements for change in progress at present, and we will provide updates on many of these as we move through 2023. Underpinning all of them is the financial materiality of the issues in question. It's for this reason that ESG issues are playing an ever more prominent role in our conversations with management teams – deft handling of a range of ESG challenges and opportunities is becoming increasingly financially material.

Looking back through history, it is striking how the most notorious examples of rapid shareholder value destruction have typically been triggered by ethical and governance failings, Enron for example, or health, safety and environmental issues, such as in the case of Union Carbide. Experience over 40 years has taught us that well-governed companies with valued products and good stakeholder relations have the best chance of long-term financial success, and this is ever more important in a world increasingly focused on ESG issues.

The information provided in this document relating to stock examples should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will feature in any future strategy run by us. Any examples discussed are provided purely to help illustrate our investment style or, are given in the context of the theme being explored. The securities discussed do not represent an entire portfolio and in aggregate may represent only a small percentage of a portfolio's holdings.

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 and 100% owned by The Bank of New York Mellon Corporation. All operations are based in Edinburgh, Scotland with a client service presence in the United States. 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
Registered in Scotland 93685. Registered Office as above. Authorised and regulated by the Financial Conduct Authority.
FCA Head Office: 12 Endeavour Square, London E20 1JN · www.fca.org.uk