WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

QUARTERLY REPORT

# QUARTERLY STEWARDSHIP COMMENTARY

*Ending 31 March 2024*

# COMMENTARY

After several years of rapid market and regulatory developments relating to Environmental, Social and Governance integration and sustainable investment, characterised by new disclosure requirements in the UK and Europe but increasingly polarised views on ESG in the US, trips to two contrasting conferences in March provided us with an opportunity to take stock of industry views.

Walter Scott colleagues attended both the US Council of Institutional Investors (CII) Spring Conference in Washington DC, and the Rights and Responsibilities of Institutional Investors Conference in Amsterdam. The CII is the leading forum in the US for bringing together asset managers and asset owners to hear from thought leaders, regulators and companies alike, whilst the long-running Amsterdam conference is particularly well attended by senior representatives from Northern European asset managers and owners.

It would be reasonable to assume that these contrasting locations and attendee lists would result in conference discussions that had very little in common, but this wasn't actually the case. To start with, there is a prevailing sense from asset owners and managers alike that 2024 is set to be something of an interregnum where it is pragmatic to wait to see what is coming next before making significant additional commitments relating to sustainable investment. In the US, the outcome of the upcoming Presidential election will set the tone for further developments in areas such as corporate climate disclosure and ESG integration at public pension plans. The robust debate around such issues has had a tempering effect on corporate sustainability commitments and indeed on the marketing material of a number of large US asset managers. Since the start of 2024, we have witnessed a number of high-profile withdrawals from collaborative engagement initiatives (and those focused on climate transition in particular).

*'Waiting to see how this all lands' was a common response from asset owners when asked about their outlook on ESG*

Although less pronounced, this tempering effect has definitely crossed the Atlantic, with a more reflective mood prevailing in Amsterdam than would have been the case even a few years ago. For different reasons, the sense of 2024 being a pivotal year was tangible. Here, it is regulation that is setting the pace of change, with the European Union's flagship SFDR (Sustainable Finance Disclosure Regulation) under review as well as new UK sustainability disclosure regulations due to come into force later in 2024. In a similar vein, landmark regulations on corporate sustainability reporting (the CSRD) will have an impact on any company with significant European operations from this year onwards. 'Waiting to see how this all lands' was a common response from asset owners when asked about their outlook on ESG and sustainable investing.

Some other common observations are notable. There is growing recognition amongst international investors that the world is confronting a number of complex, interlinked challenges, such as the relationship between climate change and increasing migration, or 'just transition' challenges which connect populist politics to the move away from the fossil fuels signalled in the COP 28 agreement. Binary restrictions in areas such as investment in the defence sector now seem somewhat mono-dimensional in the context of the war in Ukraine and rising geopolitical tensions. Meanwhile the 'on the ground' impact of AI, environmental risks and a range of social issues such as supply chain working conditions means that there is no let up with respect to the importance of long-term investors understanding the financial materiality of these and other respective issues. Generating long-term financial returns by focusing on an overtly narrow definition of fiduciary duty may be increasingly difficult to achieve in the context of unaddressed systemic risks.

On a different note, there is also renewed interest on both sides of the Atlantic (and indeed elsewhere) in hardy corporate governance perennials such as director independence, 'controlled' companies and corporate culture. The February 2024 decision of the Delaware Chancery court to void Elon Musk's 2018 remuneration plan (a remarkable $55 billion payout) has caused a ripple in corporate governance litigation circles, not least as presiding Judge Kathaleen McCormick's decision was based on the perceived absence of fair process and the actual independence of judgement of a number of remuneration committee directors deemed to be independent at least on paper. Board effectiveness and director independence are topics that we have also been focusing on this quarter at Walter Scott, both in our engagement with investee companies and in the development of our ESG research.

## *There is growing recognition amongst international investors that the world is confronting a number of complex, interlinked challenges*

It would however be a stretch to assert that even in an age of global supply chain shocks and inter-connected 'polycrisis' there are no fundamental differences in outlook between a gathering in the restrained Federal district of the US capital and one in a European city known for bicycles and socially liberal views. Whilst there is a growing sense of frustration all-round in the somewhat beleaguered profession of ESG, in the US that frustration is more typically focused on the polarisation and politicisation of a topic that should be mostly uncontentious, namely identifying and acting on all relevant factors that might affect long-term investment performance. Reflecting this, what came across loud and clear at the CII was the importance of establishing financial materiality when considering ESG factors (relevant to this debate was a rising scepticism around the value of the ESG-risks analysis provided by the rating agencies). In Europe, by contrast, there is growing frustration that constant regulatory change coupled with growing fears of regulatory censure or litigation is holding back efforts to address increasingly pressing social and environmental considerations in long-term investing.

At Walter Scott, we are of the view that some of the more sceptical ESG sentiment in the US and new international sustainability regulations have more in common than might appear to be the case at first – both are at least in part focused on ensuring that asset managers are crystal clear with their clients with respect to how they are taking account of ESG considerations in their investment process. We understand and support these broader sentiments and have very deliberately developed our approach in this area over recent years to ensure that we have clearly differentiated options for clients who wish to invest with additional sustainability objectives. Our upcoming Annual Sustainability Report will provide more details of all of our work in this important but nuanced area.

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