GLOBAL EQUITY:
ESG IN THE INVESTMENT PROCESS

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By The Nikko AM Global Equity Team

Wealthy individuals across generations are interested in investing for environmental or social impact, but Millennials are by far the most active in evaluating and indeed, demanding these strategies.

They will inherit billions of dollars saved by their baby-boomer parents and this new group of investors have different expectations as to how their money is managed. These investors are increasingly asking *how* their return is generated

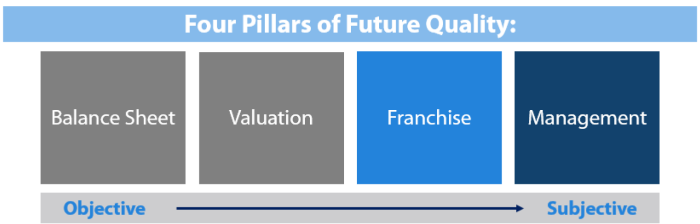
We believe this shift is secular and this paper explains how we add value for our clients by integrating ESG into all aspects of our investment process.

Executive Summary:

Building on our Future Quality white paper this analysis frames how and why we integrate ESG factors into our investment process. We have considered the growing body of academic research as well as our own investment experience; ultimately concluding that ESG is an integral part of being a fundamental investor.

There are four pillars to Future Quality investing, each contributing to the investment case. Some, such as the strength of a company's balance sheet give a picture of financial health at a set date. However, the majority of a company's value is a reflection of its future earnings – hence our focus on Future Quality. We believe these future earnings are a reflection of the strength of both the company franchise and its management. We spend a great deal of our time on the analysis of these critical variables.

Figure 1. The Four Pillars of Future Quality: Subjective Nature of Franchise & Management Quality



Like the balance sheet data, ESG ratings add value by providing a snap shot of a company's status. However, ESG factors are contingent liabilities or assets that aren't standardised and are often difficult to measure. If material, they will impact future returns and consequently corporate value, and hence it is the context behind why ESG might influence future returns that makes integrating ESG an essential part of being a fundamental investor.

Our detailed conclusions are:

Correlation: There is increasing evidence of a strong correlation between companies with high ESG scores & strong financial performance. However, there are limitations to ESG data and the data itself doesn't explain *why* ESG matters.

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Corporate Value: ESG factors influence value in many ways. The sustainability of a company's future returns can be influenced by Environmental & Social factors while Governance acts as the mechanism for establishing how a management team is likely to allocate capital in the future.

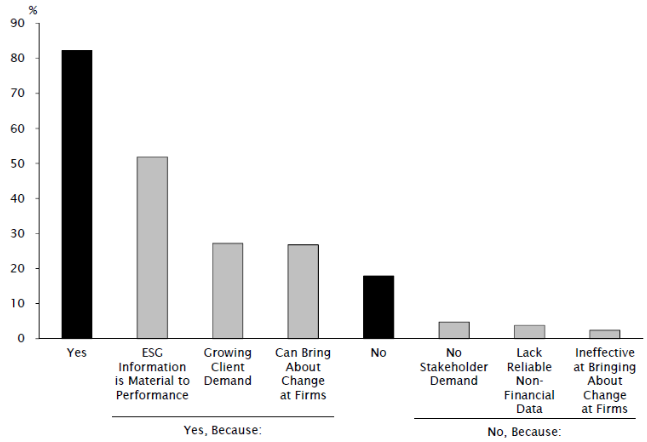
Decision Making: Engagement, in the form of investigative discussion with management through to voting, provides long-term investors with a unique position to determine which ESG factors may be material and thus are better placed to add value.

The Rise of ESG

ESG is a broad field with many different approaches such as ethical exclusion, impact investing and full ESG integration etc. What is certain and whatever your flavour, there is no doubt that interest in ESG is on the rise. But why?

If you ask the custodian, such as asset managers, they might say it is simply client driven or perhaps that analysis of ESG factors can help identify change and the potential for accelerating returns (see Chart 1 below). Certainly, the growing interest is reflected in strong asset flows across the globe[1] but none of this explains the changing attitude of asset owners.

Chart 1: ESG Survey of 'Mainstream' Investors Responses to: Do You Consider ESG Information When Making Investment Decisions? 2017



Source: Amel-Zadeh, A., and George Serafeim, 2017. "Why and How Investors Use ESG Information: Evidence from a Global Survey." Working Paper, SSRN[2]

The Age of the Millennials

Demographic trends suggest a huge transfer of wealth is in our sights. Millennials will inherit billions of dollars saved by their baby-boomer parents and this new group of investors have different expectations as to how their money is managed.

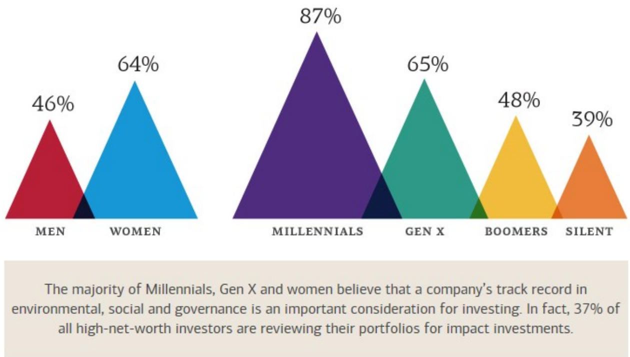
Their investments – like their everyday purchases of consumer products - reflect their personalities and need for protecting their reputation. These investors are increasingly asking *how* their return is generated.

Consider the following survey data:

- 66% of all US consumers think it is important for brands to take a stand on issues like harassment, discrimination, and diversity;
- 44% of Millennials would feel more loyalty towards their CEO if he or she took a stand on a hotly-debated issue;
- 76% of Millennials believe their investment decisions are a way to express their social, political & environmental values and 87% said that a company's impact in these areas is a key consideration when they make investment decisions.

[1] Global Sustainable Investment Alliance, 2017 Industry Report
[2] Amel-Zadeh, A., and George Serafeim, 2017. "Why and How Investors Use ESG Information: Evidence from a Global Survey." Working Paper, SSRN

Chart 2: Where will the Millennials invest?



Source: Bank of America's US Trust 2018 Wealth & Worth Report

Wealthy individuals across generations are interested in investing for environmental or social impact, but Millennials are by far the most active in evaluating and indeed, demanding these strategies. We believe this shift is secular and this paper explains how we add value for our clients by integrating ESG into all aspects of our investment process.

First, we start with a brief summary of the research.

Value of ESG Data

The reporting of ESG data is a relatively new field. MSCI only started rating companies in 2006. Given the increasing interest in the area, there is a growing body of research testing the link between ESG factors & investment performance. Research has been so plentiful, there have been a few meta- searches,[3] covering over 1,000 studies on the subject with negative, neutral and positive conclusions. In summary, consensus has been difficult to find.

For some that ends ESG integration dead in its tracks, but in our search for future quality, we have found some areas of ESG that we believe adds value.

For example, Kim et al examined the relationship between sustainability scores and earnings quality.[4] Their conclusions suggest there is a link between the quality of reported earnings and companies that are deemed to follow socially responsible practices. They found that firms that exhibit strong ESG characteristics are less likely (1) to manage earnings through discretionary accruals, (2) to manipulate real operating activities, and (3) to be the subject of SEC investigations. *Not characteristics you want to discover in a future quality investment.*

Other academic studies (Gompers et al, 2003), using a variety of indicators of effective corporate governance, have provided evidence that companies with stronger shareholder rights and management accountability have delivered stronger fundamental performance over time.[5]

More recently, MSCI published research (Cass Business school; Giese et al 2017), found data supporting the assertion that high rated ESG companies were higher quality companies compared to bottom quintile companies,[6] as measured by profitability.

Simplistically, well managed, quality companies should be effective at managing their ESG risks. The economic rationale for this transmission is explained in Godfrey et al (2009),[7] Jo and Na (2012)[8] & Oikonomou et al (2012)[9]. This body of work showed that companies with above average ESG scores typically have above average compliance standards and risk control and suffer less from severe incidents that result in significant share price loss.

[3] For example see Carpenter et al (2009); and Fulton et al (2012)
[4] Kim et al, 2012
[5] P. Gompers, J. Ishil, A. Metrick, Quarterly Journal of Economics, Vol. 118, No. 1, February 2003.
[6] Giese, Lee, Melas, Nagy & Nishikawa, Foundations of ESG Investing, November 2017
[7] Godfrey, Merrill & Hansen, 2009, The relationship between corporate Social responsibility & shareholder Value, Strategic Management Journal, Vol 30, pages 425 - 445
[8] Jo & Na, 2012, Does CSR Reduce firm risk, Journal of Business Ethics, Vol 110, pages 441-456
[9] Oikonomou, Brooks & Pavelin, 2012, The Impact of Corporate Social Performance on Financial Risk & utility, Financial Management, Vol 41, Pages 483-515

Giese et al, Gregory et al (2014)[10] & Nagy et al (2015)[11] also found significantly predictive power from moves in ESG factors. Enough for us to want to monitor ESG moves as part of our investment process.

The limitations of ESG data

Although a selective review of the research suggests ESG ratings add value, we are wary of the inherent limitations of relying too heavily on ESG data in our process.

The **first** limitation is the lack of standardisation and legal authority given to the quantification and disclosure of data by management teams. Unlike the accounting profession – with decades of standardisation backed by case law - ESG remains in its infancy.

One of the main pillars of the accounting profession is the understanding of materiality. Every day evidence of material ESG factors is wide ranging: extreme weather; Macondo; child labour, etc. However, all of these are easily identified *after* the event. Identifying a material ESG factor ahead of time, understanding how that might alter value and then if it should be disclosed is significantly more problematic. One of the common features between the Environmental, Social & Governance pillars is their contingent nature. And contingent events are inherently difficult to estimate and enforce disclosure. This issue is evidenced by the existence of the Sustainable Accounting Standard Board (or 'SASB'), which has a focused framework for targeting disclosure of ESG factors based on the SEC's interpretation of materiality.

The **second** and more often raised issue with the research to date is the inability to split correlation from causality. Academic research has identified the statistical issue of correlation mining (Harvey et al, 2016)[12] and a lack of differentiation between correlation & causality. (Kruger et al, 2015).[13] Even where some research has attempted to test the transmission mechanism behind why high ESG scores might lead to improved financial performance, researchers have suffered from a lack of data.[14] The youthfulness of the ESG data industry is an issue for those needing statistical proof that ESG adds value.

The **third** and final issue with ESG data is that most of it is backward looking. In a similar way that companies with high returns today may not generate high returns in five years' time, companies with high ESG scores today may not be tomorrow's quality companies. Finding a company in an industry with high returns or a high ESG score is not enough. Finding a good business capable of sustaining high performance requires a thorough understanding of the conditions the firm operates in and an assessment of management and its governance structure.

We believe ESG has greater value in understanding the transmission mechanisms behind why the link between high ESG scores and quality may be high. Giese, Lee et al try to address this issue by reviewing three different transmission mechanisms: cash-flow generation, tail risk management and systematic risk such as increased regulation. However, with just over 10 years of MSCI ratings data, they have concluded that data sets are too small and it is difficult to differentiate between causality and correlation.

The transmission mechanism and context is important as without that we are unable to determine if a high ESG score has led to better returns or lower risk or if the high returns have simply allowed a management team the resources to address these risks. Without understanding the transmission channel we are unable to understand how ESG might improve returns or how management might allocate capital to sustain high returns into the future.

A company's fair value (and ultimately share price) should equate to the present day value of those future returns, hence ESG is an integral part of the subjective analysis required in understanding likely future returns.

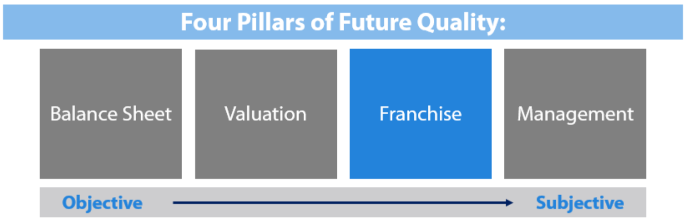
This is important because it is the assessment of a company's competitive advantage period ('Franchise Quality') and how they invest their capital ('Management Quality') that will determine the likely cash-flow returns the company will achieve in the future. We discuss how ESG impacts a company's Franchise Quality first.

[10] Gregory, Tharyan & Whittaker, 2014, Corporate Social responsibility and Firm Value; Strategic Management Journal, Vol 30, pages 633-657
[11] Nagy, Kassam & Lee, 2016, Can ESG add Alpha? An analysis of ESG Tilt and Momentum Strategies, Journal of Investing, Vol 25, No.2 , pages 113-124
[12] Harvey, Liu and Zhu, 2016, Review of Financial Studies, Vol 29, No.1, pages 5- 68
[13] Krueger,P 2015, Corporate Goodness and shareholder Wealth, Journal of Financial economics, Vol 115, No. 2, pages 304 - 329
[14] Giese et al, 2017, as above, page 26

Franchise Quality: ESG & the Sustainability of Returns

We believe the link between ESG and a company's future returns is intuitive and hence ESG is a core part of understanding the franchise quality of a business, one of the four pillars of Future Quality investing.

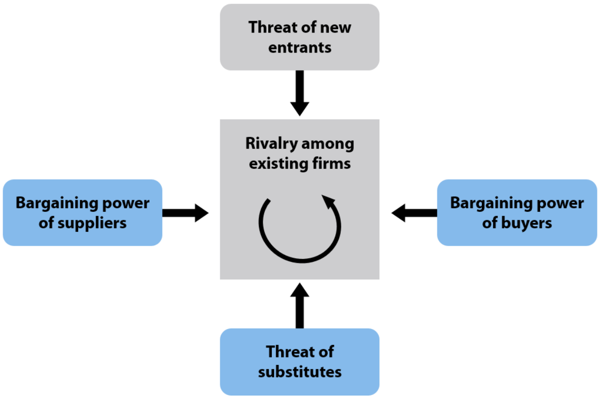
Figure 2: The four Pillars of Future Quality: Franchise Quality



Porter's 5 forces: the competitive advantage period

Michael Porter's 5 forces framework[15] is regarded as the gold standard for analysing competitive advantage periods and understanding how external forces within an industry might alter a company's future return profile, or what we call Franchise Quality.

Figure 3: Michael Porters Five Forces That Shape Industry Structure



Source: Michael E. Porter, Competitive Strategy (New York: The free Press, 1980).

Importantly this framework demonstrates that a firm does not operate in a closed loop. External forces will undoubtedly have an impact such as how suppliers or consumers behave.

Traditional theory, based on Graham & Dodd's 'Security Analysis', provides a logical approach for making investment decisions and requires a qualitative assessment of financial performance & value. Analysis by experienced investors of a wide variety of public information, supplemented with management interviews combine to create a mosaic approach to long-term investing.

The historical foundation of this approach assumes that value is aligned with book cost, however, this link has dissipated over the past few decades as capital intensity has decreased and the hold of technology on society has taken root. Intangible assets, such as brand value, reputation, trust, R&D pipelines, employee turnover, equality etc., have all had increasing influence on management action & returns.

According to Mauboussin et al (2013),[16] there are three broad sources of added value: production advantages, consumer advantages, and external factors. Production advantages are easier to contextualise and may include resource or production economies of scale. Consumer advantages are more prevalent in today's technologically advanced society with natural network effects for companies such as Google.

Mauboussin calls the final factor impacting value as 'external'. Issues here include subsidies, tariffs, quotas, and both competitive and environmental regulation. Changes in government policy can have a meaningful impact on

[15] Porters Five forces, Michael E. Porter, Competitive Strategy (New York: The free Press, 1980).
[16] Mauboussin, Callahan & Majd, Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, October 2016

corporate value. Consider the impact of deregulation on the airline and trucking industries, Basel III on financial services, or subsidies on the solar energy Industry.

Porter's 5 forces & ESG

An obvious area of focus in the ESG field has been on the external forces created by environmental legislation and its impact on a firm and industry returns, most relating to carbon pollution. Many investors simply address this issue with exclusion policies, however this approach may be too simple.

On the subject of exclusions, Porters work on the competitive advantage period and the impact of environmental legislation is controversial. Porter's research suggests that strict environmental regulation does not hinder competitive advantage periods but can often lead to further advances.

This has been tested many times as summarised by Ambec et al.[17] and concludes that there is a positive link, although varying in strength, between regulation and innovation. This work confirms our view that integrating ESG isn't confined to only minimising risk but can also offer up investment opportunities too.

Of course using the word 'external' is a misnomer. Regulation, the environment, waste, diversity, employee safety, etc. are all part of the company's ecosystem.

Figure 4: The Competitive Advantage Period And A Company's Ecosystem

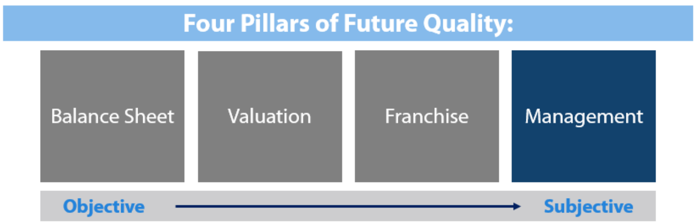
Source: Nikko, Harvard Business Review, Creating Shared Value – Michael Porter and Mark Kramer

Companies do not operate in a bubble and with the increase in penetration of social media, management teams are increasingly aware of how Environmental, Social & Governance factors can influence future returns. How & why management invest capital will also have a significant bearing on returns.

Management Quality: Governance and the allocation of capital

Governance is the mechanism for how a company achieves its objectives and our understanding of it and role of management is key to determining if capital will be deployed effectively.

Figure 5: The four Pillars of Future Quality: Management Quality



[17] Ambec, Cohen, Elgie & Lanoie, 2010, The Porter Hypothesis at 20: Can environmental regulation enhance innovation and competitiveness,

Since the world of business is dynamic, companies must constantly assess trade-offs and make difficult decisions. A clear strategy & objective will provide all stakeholders with the starting point for assessing a company's prospects and evaluating performance.

Corporate behaviour is also impacted by local law, customs & culture. As a general rule, companies that operate under common law – mostly Anglo Saxon – have the strongest protection for shareholders, whereas those operating under civil law have weaker protection for shareholders and stronger protection for other stakeholders, such as creditors.

These different starting points perhaps explain why countries with a bias towards shareholder value also generate higher returns than those with a more balanced stakeholder approach. However, as is so often the case, the statistics don't tell the whole story and to conclude that one country or approach is preferred would be wrong.

Despite these differences, the framework for analysing governance & management has not changed over the years. Graham & Dodd,[18] in the original edition of their classic *'Security Analysis'*, raised the question of governance by emphasizing potential conflicts of interests between stockholders and corporate management. The lack of information or control faced by 'outside' investors – known as the agency problem – is well known and the nature of the issues during the start of the 20th century remains the same today.

Agency theory is the classic way to explain why management action may not be aligned with shareholder interests. There are three areas in capital allocation where these conflicts may arise:

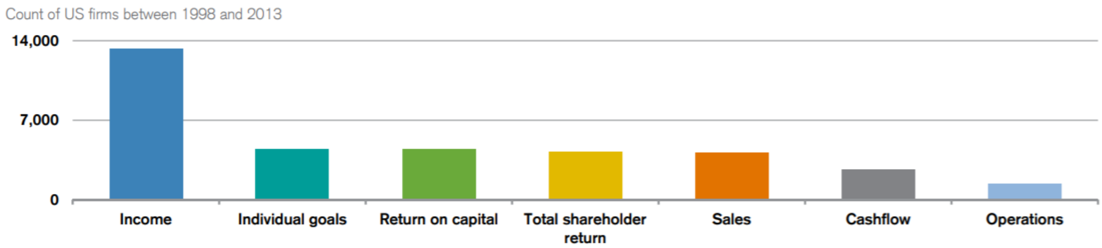
'Size isn't everything': Company size is a crude proxy often used for remuneration and may lead management teams to empire build.

'Long shots': Management teams may have a different risk tolerance and may undertake high risk strategies to achieve remuneration goals.

'Short termism': Different time horizons can also lead to unwanted behaviours. The most common being the focus on short term returns or targets.

Determining the right incentive scheme for a company is difficult. We can certainly point to the dominance of earnings based measures within incentive schemes – and in particular, 'adjusted earnings' – as a concern for long-term investors. This is illustrated below:

Chart 3: Use of Incentive Metrics – 1,721 US Companies



Source: CSFB Holt Governance Database, ISS

The focus (and failure) of short term incentives is of particular concern given the debate over timeline is ultimately meaningless. There should only be one aim and that is to generate value. This applies to activities that management expect to deliver value both in the short term and longer term.[19]

Ultimately good ESG disclosure, appropriate long-term incentive schemes and a governance structure that protects shareholders' interests are all positive signals but in themselves are not substitutes for the value created from engaging with management.

[18] Graham & Dodd, Security Analysis, 1934
[19] Alfred Rappaport , 2011' saving capitalism from short termism: how to build long term value and take back our financial future (NY: McGraw Hill, 2011, pages 140-142)

Engagement: why engagement creates value

To have a greater understanding of how ESG may impact future returns, engagement with management should be a key goal for any fundamental investor. Discussions with management regularly help us contextualise the likely success of future capital allocation decisions and how ESG factors may impact future returns.

Research to date – though limited – has shown a link between engagement and long-term value. (Blackrock & Ceres[20] & Dimson, Karakas & Li[21]). The full value gained from appropriate engagement is best illustrated by the following table developed for PRI by O'Sullivan & Gond from Cass Business School[22]:

Figure 6: How Engagement Creates Value

VALUE CREATION DYNAMICS	CORPORATIONS	INVESTORS
COMMUNICATIVE EXCHANGING INFORMATION	Clarifying expectations and enhancing accountability	Signalling and defining ESG expectations
	Managing impressions and rebalancing misrepresentations	Seeking detailed and accurate corporate information
	Specifying the business context	Enhancing investor ESG communication and accountability
LEARNING PRODUCING AND DIFFUSING KNOWLEDGE	Anticipating and detecting new trends related to ESG	Building new ESG knowledge
	Gathering feedback, benchmarking and gap spotting	Contextualising investment decisions
	Developing knowledge of ESG issues	Identifying and diffusing industry best practice
POLITICAL DERIVING POLITICAL BENEFITS	Enrolling internal experts	Advancing internal collaboration and ESG integration
	Elevating sustainability and securing resources	Meeting client expectations
	Enhancing the loyalty of long-term investors	Building long-term relationships

Source: PRI, O'sullivan & Gond,[23] Cass Business School, 2018

Although we are active investors we are not activists. Our engagement with management teams is to understand how they can achieve high returns and allows us to assess if they are good stewards of our clients' capital. Rather than agitating for change we would prefer to work constructively with management teams, although we will seek change if we feel the sustainability of returns is at risk.

Voting is another important area of engagement. We vote on all matters put to shareholders, following our voting guidelines, investment philosophy and of course our clients' wishes. In normal circumstance we support company management, however, we will withhold support or oppose management, if we believe it is in the best interests of our clients.

Conclusion

As Future Quality investors, we want to know whether the company has a sustainable competitive advantage, whether the company has an organizational and governance structure that will help management maintain and enhance that competitive advantage and a structure that provides management with both accountability and strong incentives to add value. We are also looking for evidence that management is thinking about the company's future; about what the organisation will look like in 10 - 15 years from now.

To those who would question the relevance of ESG to investment analysis, we submit that the debate over materiality will continue. However, we believe long term, active investors have the opportunity to add value by integrating ESG factors into their analysis. We believe ESG is another lens through which to implement our Future Quality philosophy.

[20] Blackrock & Ceres, (2015), 21st Century Engagement, Investor Strategies for Incorporating ESG Considerations into Corporate Interactions
[21] Dimson, Karakas & Li (2015) Active Ownership. *Review of Financial Studies*
[22] A Cass Business school and PRI paper, 'How ESG engagement creates value for investors and companies'
[23] (O'sullivan & Gond , 2018)

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