INTEGRATING ESG IT'S JUST GOOD BUSINESS

From The RBC Global Equities Team

Environmental, social and governance (ESG) investing has gone from being a tangential topic for investors, to becoming an increasingly important consideration in the decision making process. However, while there is appetite among institutional investors, asset owners and plan sponsors to better integrate ESG into their investment processes, there is also a concern that prioritising ESG factors could interfere with their fiduciary duty.

The RBC Global Equities team has engaged with ESG issues since our investment track record began in 2006. Our experience is that there need not be any conflict between fiduciary duty and accommodating ESG factors and that, in fact, the two are often complimentary. The following paper looks at why this is the case and how we have integrated the consideration of ESG into investment processes. We also share examples of where ESG insights have changed portfolio construction with positive consequences for overall portfolio returns.

What is ESG?

For those who are unfamiliar with ESG, the response to taking into consideration these factors can be apathetic. After all, ESG issues do not explicitly feature in most financial reporting. There is no obligatory or formal disclosure of the firm's environmental footprint or its social impact and governance disclosures are often patchy. Instead, financial reports focus on elements with a more tangible monetary value, such as assets and liabilities, income and expenditure and cash flows.

But if we take a step back and consider the bigger picture, regardless of a manager's opinion on the qualitative importance of ESG, it is unquestionable that these factors are all indirect inputs into those financial results. Every company relies upon the cooperation of its workers, upon access to capital to fund its activities, and upon the trust of customers and suppliers and neighbours. So instead of approaching ESG as a distinct issue separate to financial health, we should really approach ESG issues as non-traditional sources of risk. What's more, they also represent an opportunity.

ESG issues are non-traditional in that they largely lie outside formal reporting structures and as a result are often neglected in traditional financial analysis. But being 'non-traditional' doesn't mean that ESG factors matter any less as a potential source of risk. After all, few of us would want to be invested in a firm that loses the trust of its employees, suppliers or customers. A company with poor consideration of ESG issues will find itself at a disadvantage to competitors that give these more attention. For example, not investing in staff training or ignoring health and safety will over time impact staff retention and in turn, labour productivity. A firm that invests in these, however, will not only have a happier workforce but also lower unit costs due to increased productivity, giving it a financial edge. When implemented in a thoughtful way, ESG can lower costs, improve access to capital and help firms uncover new opportunities.

A good example of this is the concentration of laundry detergent liquids. Reducing water content in detergents not only minimises usage of a precious natural resource, it cuts down packaging and transportation costs and gives the consumer a less expensive, lighter product with no impact on effectiveness. Consumer goods companies and retailers at the vanguard of this change, who also noted positive customer feedback, were able to take market share.

Asset owners are not the only ones who stand to benefit from well-thought integration of ESG. Workers benefit from job security, suppliers are able to plan for their future and the sustainable use of resources doesn't compromise opportunity for future generations. This is positive for asset owners, but also benefits society as a whole. This is responsible capitalism which places asset owners in a very important position, as they have the ultimate responsibility for how their businesses are run and the decisions management makes on their behalf.

If asset owners mistakenly believe that ESG considerations somehow conflict with their fiduciary duty there will be nothing to stop them permitting, or even incentivising, management to make decisions to the detriment of wider ESG concerns. This might well have the effect of boosting profits in the short term but it will create an inevitable future problem. With no formal obligation to take ESG into account, they may even step back entirely, becoming passive investors. This is a naïve strategy and one that could potentially damage long-term performance.

For asset owners faced with long-term liabilities, the impact of robust ESG on the future financial results of a company should make ESG a central concern. At the same time, for those investing over a short-term horizon, the likelihood of an ESG issue materially impacting performance is very small, although it can and it does happen. However, over the long-term it is inevitable that ESG short-cuts taken by companies will be exposed, while the cumulative benefits of good ESG will become apparent. Far from being contrary to their fiduciary duty, it is in the financial interest of asset owners to understand and assess ESG issues. Indeed, owners have ultimate responsibility and so stand to be held accountable by the rest of society for the actions of the businesses they own.

Screening versus integrating

If one accepts ESG is important to a company's long-term financial performance, it is logical that it be incorporated into the investment process. Early attempts at this within the investment management industry began with a screening process which excluded companies from portfolio selection on the basis of what they do.

While this is a reasonable place to start, it has a number of limitations. The first issue is the lack of comprehensive and comparable data over companies' ESG. This would allow companies to be compared and poor performers weeded out. However, formal reporting on these metrics can be patchy with widespread geographical differences. What's more, individual data points will have variable significance dependent on the company and industry. For example, water usage is an important indicator in assessing the environmental impact of a resources company, but will be almost irrelevant for an advertising agency. As a result, if the data isn't complete or there are no consistent metrics for comparing across industries, the output of the screens could give some questionable results.

The second issue is that screening out 'bad companies' is only half the story. Companies with good ESG may be able to convert their approach into long-term commercial success. However, negative screens are ineffective at identifying a company's potential competitive advantage. Negative screens focus on risks but ignore opportunities.

What's more, the screening process itself was often simply tacked on to the front of an existing investment process, typically as a way of filtering the investment universe. While better than doing nothing at all, the manager making the buy decision ended up having very little understanding of why a particular company had made it through the screen. Moreover, because the screening was distinct from the buy or sell decision, the manager was given very little incentive to understand ESG issues and it was almost impossible to see how they were included in any assessment of fundamental value.

Ultimately, screening was at best a good place to start and may still have a role for some specialist mandates, but cannot be considered the ideal approach.

To address the shortcoming of basic screening models, some managers have set up dedicated ESG Teams. These teams have a better understanding of the data and are able to improve the usefulness of screens by ensuring they are relevant, complete and consistent. They have also been able to improve managers' overall understanding of controversial issues, putting them into context and providing advice on voting at annual general meetings.

This is undoubtedly an improvement, but there is an opportunity to take it further through complete ESG integration.

Fully integrating ESG into the process means that the person making the investment decision, the 'risk-taker', is in possession of all the facts, can determine how they impact the investment case, including valuation, and is in a position to engage with the managers of the business representing the interests of asset owners. It ensures that there is no gap between the assessment of ESG and the investment decision. Both are embodied in one judgement by the investor. Company comparisons across industries become easier and a clear link between ESG and valuation is established.

We believe that the RBC Global Equity team's structure of seven industry experts, well-versed in the comparable universe of ESG factors, enables us to achieve this integration. Importantly, each industry expert is not only responsible for assessing companies in their respective industries, but through collective discussion and ranking of opportunities, shares responsibility for the construction of portfolios. There is no separation between ESG and fundamental assessment. Neither is there any distinction between the traditional roles of analyst and portfolio manager in the team. The industry experts are all investors and risk-takers who share a common culture of ESG awareness and knowledge.

Importantly, each industry expert is highly experienced in their respective fields giving them an in-depth understanding of key ESG matters within each sub-sector. This has practical benefits as they are able to engage with companies from a position of knowledge and understanding.

The issue of engagement is a vital aspect of ownership. Asset owners entrust their wealth to investment managers whose duty it is to represent their interests. An owner of a business must care about how their capital is put to use - equity shareholders can and do lose everything if a business fails so they have every incentive to care. Clearly they will want to see a satisfactory return but a responsible owner will also want to ensure that their return is not being generated at any cost. If a company cuts corners it will be borrowing profit from the future to boost profits today. This is not a sustainable strategy as that debt will have to be repaid in some form.

Companies that 'borrow' in this way are unlikely to have good ESG and be sustainable. This activity can come in many forms; borrowing from the firm's assets by under-investing; borrowing from employees by not training; borrowing from customers by letting service slip. The result is that short-term profits may look impressive, but will have been achieved while accumulating a liability that must be repaid eventually and could well leave the owner worse off.

Representing the owners' interests through engagement is not only a duty, but is also potentially beneficial for the owners' wealth. There are three reasons for this. First, it ensures good stewardship of the asset owners' original capital. Second, actively engaging with a business increases knowledge and understanding. This helps the investor form a more accurate assessment of the firm's risks and opportunities which leads to an improved understanding of the company's valuation and as a result, better decision-making. Third, engagement can effect corporate change and improve businesses. Disapproval or encouragement can help steer a company's actions along a particular path, with voting at company meetings the most typical and most public means of achieving this. This can even lead to improvements with a broader social benefit, such as auditing supply chains to eliminate the use of child labour.

Unfortunately, it is not the prerogative of all investors to engage with the companies they own. In particular, many passive investors who choose to own a company because it has been selected for inclusion within an index may seek to interfere as little as possible in order to reduce cost and avoid influencing the index they are looking to replicate. These investors might consider themselves to be fully-invested, but they do not exercise true ownership in practice.

How we integrate ESG into our investment process

We as a team make an explicit judgement on management and ESG as part of our assessment of the companies we invest in. This assessment examines the four key attributes that we look for in every potential investment.

Business Model	The unique element that gives the business a sustainable edge over competitors
Market Share Opportunity	How effectively a winning business model will take market share
End-Market Growth	A winning business model should be exposed to growing end markets
Management & ESG	Management that takes the right strategic decisions and operates in a responsible and sustainable manner

We refer collectively to these attributes as 'Competitive Dynamics'. Companies with strong Competitive Dynamics should deliver superior shareholder value over the long-term. We never invest in a company unless all four are present and only own companies in a portfolio that combine strong Competitive Dynamics with an attractive valuation.

Our assessment of ESG recognises that management's consideration of these factors is discretionary. It can choose to engage with ESG issues and manage the business so that it has a sustainable future, or it can ignore ESG issues, perhaps buoying short-term profits, but compromising the sustainability of the business. We think management should be held accountable for these choices.

ESG issues also have an impact upon the other three forces of Competitive Dynamics. For example, a bulb manufacturer's choice to move into low-energy LED technology may enable it to take market share from

Investment

Example: Swiss pharmaceutical company

The Company's very strong ESG credentials are observable throughout its business model. Its chosen field of oncology is an area of expanding scientific knowledge but it is also one with broad social benefits given the number of lives cancer impacts. By fulfilling patients' unmet needs, the Company is able to deliver a significant improvement to the duration and quality of patients' lives. It has become a trusted partner for medical practitioners because of the quality of its work, enabling it to collaborate on new areas of research. Management has a strong record of meeting its regulatory obligations and we were able to note the supportive employee culture.

Divestment

Example: US based teen retailer

After being invested for a period of time we became increasingly concerned over the quality of the financial results. In particular, a write-off of newly delivered inventory because it was deemed inconsistent with brand values highlighted potentially weak management controls. This was exacerbated by signs of over-investment when opening in new regions and the adoption of unsustainable pricing structures. Having repeatedly questioned management on these issues, the upcoming expiration of senior management's generous employment contract provided the catalyst for more detailed discussions. However, we were disappointed that despite our discussions, when the new contract was signed there was no evidence that our concerns had been addressed. We were obliged to reassess our view on management and ESG which ultimately led to our divestment from the company.

Engagement

The way that we integrate ESG into the fundamental company assessment has a direct impact upon whether we buy or sell. But not all ESG issues have to lead to a decision to sell our shares. Indeed, acting as an owner and engaging with a business can have a more subtle impact over time which brings about improvements.

Example: European manufacturer of baked goods
The Company had enjoyed a number of years of success during which it had been able to expand both organically and via acquisition into adjacent categories of baked goods as well as new geographies and channels of distribution. As the business had grown from a mid-size local firm to a large international company, we believed it was now at a size and maturity where it was appropriate to expect more detailed levels of social and environmental disclosure. We engaged with management to encourage a change in reporting. Management was receptive and ultimately provided the enhanced disclosure we were seeking.

Avoidance

Example: US 'energy' drink company
Our screening of fundamental company and industry data within the beverage segment highlighted very strong sales and margins for this company selling a widely known brand of highly caffeinated carbonated soft drinks. However, closer examination revealed a business that we felt was stretching the bounds of social responsibility. We were particularly concerned with its marketing and packaging. Labelling high-caffeine drinks as 'energy' is potentially misleading and could be detrimental to the health of the young people at whom they seemed to be marketed. We were concerned that the large 500ml cans with cartoon motifs and action-sports / gaming promotions were too closely targeting this vulnerable demographic. The social cost of this would eventually be recognized and the product could ultimately be subject to some form of regulation. The financial impact of potential regulation was not yet reflected in the valuation and we ultimately decided to avoid this investment.

manufacturers of less efficient bulbs. The technology itself may give the manufacturer a competitive advantage which would clearly be positive for our assessment of Competitive Dynamics. It could also be argued that the strategic shift away from phosphorescent bulbs to LEDs is itself driven by environmental concerns as well as responding to customer demand and policymakers favouring low emission technology. These factors are equally important - we believe that making an explicit judgement on a business's ESG is still relevant as 'how' a business is operated is no less important than 'why'.

We utilise a wide array of information sources to inform our ESG assessment. Multiple points of view are essential in providing a balanced and reliable perspective. Some focus on accounting judgements, some on governance, some on corporate culture and some on environmental or reputational issues, as follows:

RBC GAM Corporate Governance and Responsible Investing Team	Company Reporting
Industry Reports	Bloomberg
Carbon Disclosure Project	Glass-Lewis
Glassdoor	HOLT risk
ISS	Maplecroft
MSCI	Sustainalytics

Impacting outcomes

From considering these non-traditional sources of risk and opportunity we are able to develop a richer, broader set of information which feeds into our Competitive Dynamics assessment, in particular our 'Management & ESG' judgement. We will never invest in a company that fails any one of our four Competitive Dynamics, so a negative assessment in 'Management & ESG' will preclude ownership. We will also sell our shares in a company if our judgement moves from positive to negative.

Proxy Voting

As part of our commitment to engagement we ensure that we examine and vote through proxy. This is led by the relevant industry expert on our team, who because of their specialist knowledge and familiarity with the company, is ideally placed to assess proposals and, if necessary, engage with management. Whenever possible, we will collaborate with investment teams across RBC GAM to ensure our concerns are heard through as many channels as possible.

Every company we consider has to meet our Competitive Dynamics criteria but that is not sufficient for investment. It also has to be under-valued, as we see no point in owning an over-priced company, which simply puts capital at risk and offers less scope for price growth. There are also many ways of assessing valuation accurately. A very common approach is to use a 'price/earnings ratio'. This compares the current value of the company to the expected profits attributable to the owners in the future. The higher the profits, the lower the ratio and the more attractive the valuation. The dividend yield, which compares next year's dividend to today's share price, can also be used.

Both ratios are useful, but like any ratio that relies on a point estimate of a year's profit or dividend, there are particular limitations when incorporating ESG into a valuation. Environmental, social or governance issues may take time to become apparent and a ratio that uses next year's data may miss the profit impact of an ESG risk or opportunity if it is expected to emerge after that. Investors who rely on a price/earnings multiple to select potential investments may even be erroneously drawn to businesses that are using poor ESG to 'borrow' future profit in order to flatter results today.

For these reasons we favour using a long-term valuation methodology: a discounted cash flow. As this looks at a longer time horizon, it is possible that ESG factors are likely to play a more important part in a company's performance. ESG can thus be appropriately integrated into the valuation assessment. Discounted cash flows do rely on assumptions, but the better the assumptions, the more relevant and accurate the output is likely to be. By adopting a longer term horizon and a more holistic set of assumptions that include ESG, it should be possible to derive a more informative assessment of the company's fundamental value.

Summary

Incorporating ESG considerations in the investment process doesn't have to be daunting. Indeed, many investors will find that by seeking to understand the broader context in which a firm's financial results are achieved, they are already considering many aspects of ESG in their decision-making. Ensuring that this is woven into the investment process so that it becomes an integral part of the risk-taking judgement can be challenging. We believe that having an ownership mind-set certainly helps in establishing this behaviour. When applied in a thoughtful way, considering these issues will enable investors to approach decisions with a broader, more complete set of information. This can ultimately help improve investment decisions and support investors in achieving their objectives. While this should be reason enough to integrate ESG into investing, the benefits of doing so can be felt far beyond the investment world in the social and environmental good that companies can achieve. Good ESG, at its heart, is simply good business.

Authored by:
Ben Yeoh, Senior Portfolio Manager, Global Equities
Jeremy Richardson, Senior Portfolio Manager, Global Equities
RBC Global Asset Management (UK) Limited

For more information, please contact us at:

RBCGAMUKmarketing@rbc.com

www.rbcgam.com

Global Asset Management