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In focus

The pursuit of sustainable growth:
Are investors asking the right questions?

All too often investors tend to look at ESG analysis as something that can be distilled into a simplified score or conclusion. We believe that this can create a false sense of security and an investment approach that can fall short of its aims. ESG analysis will always be subjective and a matter of degree, rather than a conclusive, data-driven absolute truth. Ultimately ESG is an approach to looking at companies. What things are we fundamentally trying to understand about those companies? What questions should we be asking?

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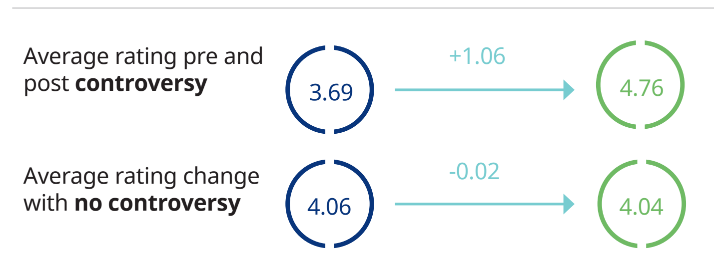
Corporate sustainability lies at the heart of companies' business models, encompassing the role they play in society and their commitment to building deep roots in their relationships with stakeholders. Sustainability cannot be fully captured by a list of metrics in a rigid framework. It requires a deep understanding of both business models and the social context in which they operate.

Figure 1: Selected MSCI ratings and their changes pre and post controversy events

Name	MSCI Pre Event	MSCI Change	MSCI Post Event
BHP Billiton	A	-1	BBB
Volkswagon	BBB	-3	CCC
Toshiba	AAA	-3	BBB
Olympus	AAA	-6	CCC
Valeant	CCC	0	CCC
Siemens	AAA	0	AAA
Tesco Plc	A	0	A
Compass Group	A	-1	BBB
Carnival	BB	-2	CCC
BP	AA	-3	BB
Barclays	A	-3	B
Comcast	B	-1	CCC
Compass Group	A	-1	BBB
Costco	BBB	-3	CCC
Dixons Carphone	BBB	-1	BB
Experian	A	-1	BBB
Target	BB	-2	CCC
Sports Direct	A	-1	BBB
Lloyds	BBB	-3	CCC
Vodafone	AA	1	AAA



Source: MSCI, Schroders. Ratings adjusted as to numbers as follows: AAA=1, AA=2, A=3, BBB=4, BB=5, B=6, CCC=7.
The companies mentioned are for illustrative purposes only and not a recommendation to buy/sell. Ratings are subject to change.

As a result, we do not believe third party scores (such as those offered by MSCI and Sustainalytics etc.) can provide the depth of insight that fundamental investors consider important. While we recognize that ESG ratings can be a useful input into analysis, they are not a replacement for thorough and thoughtful analysis.

First, third party scores are inherently backward-looking and infrequently updated. In addition, the methodology used by the different agencies is very opaque, and there is remarkably little consistency between their scores, despite ostensibly similar approaches. These points are illustrated in Figure 1, where we show the lack of correlation between ESG scores from the two main providers, MSCI and Sustainalytics. The inconsistency highlights a central challenge to ESG analysis in much of our industry; there is a tendency to treat ESG ratings as "an answer" which can be formulaically applied to investment decisions. In practice, any ESG scores represent a perspective from a particular vantage point. Without understanding the lens applied, it's difficult to rely on ratings to provide a useful basis for stock selection.

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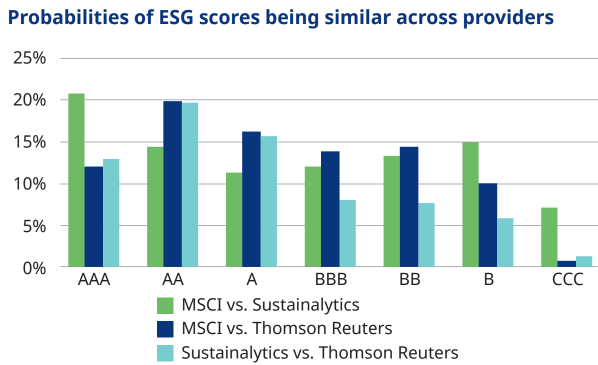
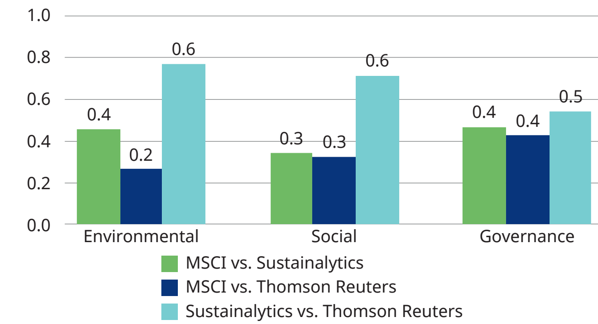
Figure 2: Lack of consistency between different ESG ratings



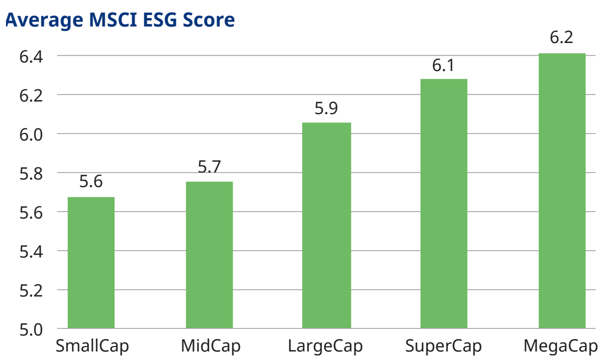
Source: Schroders, December 2017



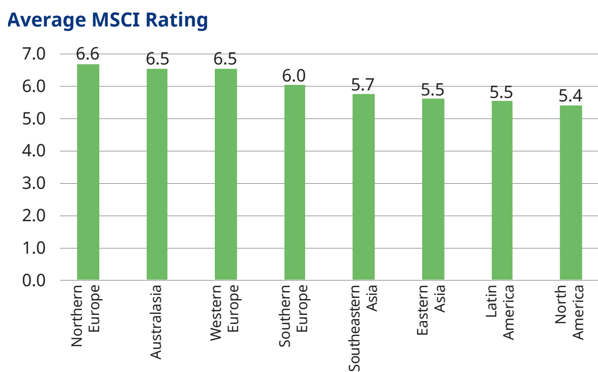
Source: Schroders, March 2018

Lastly, these scoring systems can only be based on reported metrics and policies as they inevitably reward disclosure (or, uncharitably, 'greenwashing') rather than a genuine commitment to sustainable business practices. Recent research from Goldman Sachs highlights that ratings services tend to incorporate upwards of 100-200 inputs, but 80% or more of those inputs relate to policies rather than more tangible measures of performance. This results in a natural bias towards large-cap, often European companies, which are more likely to have comprehensive policies. In some cases, this is purely due to regulatory/listing requirements rather than corporate virtue. For example, large UK companies are required to publish a tax policy, but the quality and substance of the disclosure still varies widely, and the presence of a policy in isolation tells you nothing about whether they take a socially responsible approach to their tax affairs.

Figure 3: Lack of consistency between different ESG ratings



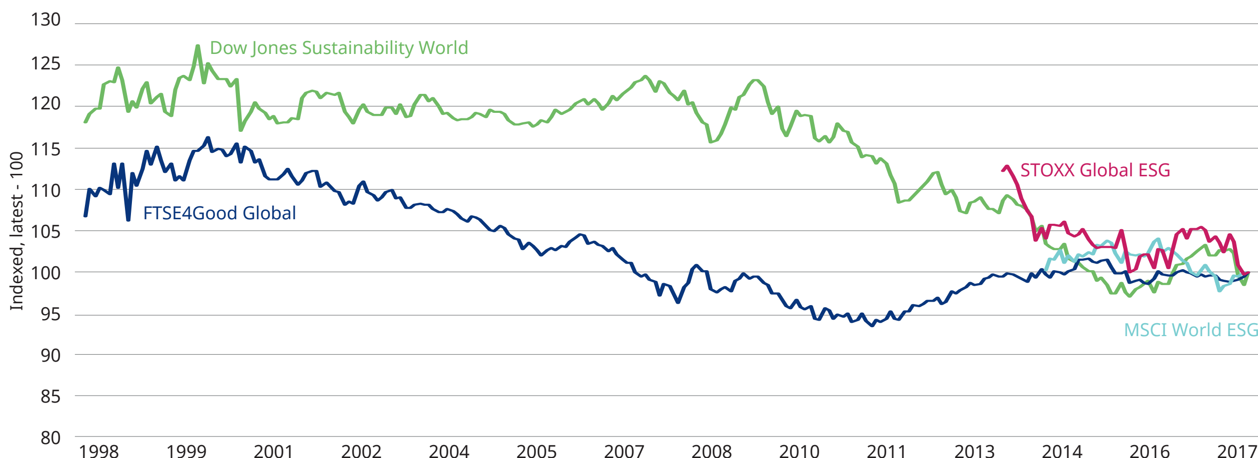
Source: MSCI, August 2018



Source: August 2018

These shortcomings are part of the reason most passive ESG funds have had lackluster performance, as shown in Figure 4 below. The other issue, in our view, is that they select stocks based purely on ESG performance, completely ignoring company fundamentals and valuation. This misses the fact that a 'good' company is not always a good investment.

Figure 4: Performance of common ESG indices relative to conventional equivalent



Source: Thompson Reuters Datastream, August 2018. Past performance is no guarantee of future results. Investors cannot invest directly in any index. Actual results would vary due to, among other things, fees and expenses.

Perhaps our most serious objection to relying on third party scores is that it is insufficiently rigorous as a basis for stock selection. After all, the reality is that any assessment of sustainability will always be subjective and a matter of degree, rather than 'absolute truth', which can be revealed by crunching enough data. Furthermore, integrating ESG within a fundamental analysis framework requires skill in asking the right questions. For investors seeking sustainable growth, it's important not to naively 'screen' companies based solely on a quantitative screen.[1]

In our view, the right framework begins with asking the right baseline questions:

1. Does a company's operations demonstrate respect for the environment?
2. Do they seek to demonstrate fair and equitable treatment of employees, suppliers and customers?
3. Do they make meaningful attempts to be good corporate citizens?
4. Are they prudent allocators of capital?

1 Schroders, as a firm, does adhere to the exclusion of any companies which derive revenue from the business of cluster munitions and anti-personnel mines.

Our sustainability assessment is designed to provide a holistic, in-depth assessment of the long-term durability of a company's business model and growth prospects, based on a deep understanding of stakeholder relationships. The analysis is framed around four broad pillars, which are subdivided and formulated into 20 questions rather than criteria in order to stimulate in-depth debate and discussion rather than becoming a 'box-ticking' exercise. For each question, we analyze the company's strengths and weaknesses using a wide range of sources, going well beyond official company publications. We regularly reach out to the company directly while working through the analysis in order to fill gaps in disclosure and deepen our understanding of company practices. We aim to assess the company's strategy, culture and depth of commitment to sustainability, rather than just its disclosure levels.

Figure 5 shows a working example of how applying a fundamental 'sustainable growth' framework offers a contrarian view on two stock selection considerations. In this instance, despite high ESG ratings for Kubota (a Japanese heavy equipment manufacturer), it was determined that there was not adequate capital allocations, as well as poor workforce trends. Terumo, however, graded very highly from a fundamental perspective, despite low ESG marks.

Figure 5: Do third-party ratings really help answer the questions surrounding the pursuit of sustainable growth?

	Kubota – REJECTED **Sustainalytics: 94%, MSCI: A**	**Terumo - ACCEPTED** **Sustainalytics: 45%, MSCI: BB**
Respect for the environment	**STRONG** – Target 60% of sales from eco-products; conducts life-cycle assessment for products – Comprehensive environmental policies with board-level oversight and ambitious targets	**MEDIUM/STRONG** – Product environmental footprint not material – Minimal resource-intensity but disclosure and efforts to manage corporate environmental impact are impressive – has been setting environmental targets since 1990 with strong track record – Provides site-level environmental data for all plants
Fair and equitable treatment of employees, suppliers and customers	**WEAK/MEDIUM** – Poor gender diversity (c10% women) & employee satisfaction – Weak health & safety record and procedures – Limited evidence of supply chain management; high payables – Regular recalls	**STRONG/VERY STRONG** – Detailed disclosure around employees indicates genuinely value and look after staff. Actively promotes healthy work-life balance and flexible working including for fathers – Efforts to bring retirees back into the workforce as 'experts', >70% of retirees are rehired – Offers counselling service and independent legal counsel for employees wishing to raise HR grievances – Regular supplier surveys – Products high quality and good value for money: low % of procedure cost. Preferred by surgeons
Good corporate citizens	**MEDIUM/STRONG** – No tax or regulatory issues – Comprehensive internal risk management, ethics training and annual audits. Whistle-blower protections – Limited evidence of community/charitable efforts	**STRONG** – Positive externalities from enabling minimally invasive surgery: lower risk & cost – Regulatory risk material, recalls are common in this sector. Historic issues but seems appropriately managed and improving track record – Low reimbursement risk – Strong internal controls on corruption and antitrust. Whistle-blower protections – Long-standing UN Global Compact signatory and references SDGs in reporting
Prudent allocation of capital	**WEAK/MEDIUM** – Lack of disclosure on management compensation; appears to be largely fixed salary with bonuses linked to short-term performance and no stock-based component – Mid-term business plan lacks auditable targets – Very low board independence and no women on board – Lack of disclosure and access to management makes it impossible to have conviction in long-term strategy or commitment to sustainability	**MEDIUM/STRONG** – Improver on governance. Have unwound cross-holdings in recent years and growing share independent board members. Engaged with company and confident they are taking this seriously – Accounting clean and strong cash conversion – Management open and accessible to foreign investors – Strong CSR disclosure Board member responsible for EHS and executive responsible for CSR

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Responding to controversies: asking the right questions is key

Our appraisal of sustainability is dynamic, since news flow, company results, new data, and insights from company meetings are also dynamic. So too are managing controversies. As long-term investors, a material controversy should not always trigger a reactive, knee-jerk sale. Rather, a prompt and immediate review, possibly also placement under 'quarantine' is much more prescriptive, especially since in many cases controversies have tended to be acute. We realize that some degree of controversy risk is unavoidable even for companies with strong sustainability standards, so we focus our assessment on (a) what – if anything – the controversy reveals about the company that we did not know before, and (b) how they respond to it. This is a fundamental flaw in reliance on third party ratings, they are neither dynamic nor forward-looking.

Company engagement: diligence requires more than a standard questionnaire

As a firm, we proactively and specifically target our engagement activity. While our process is designed to identify companies that are already well run, we have yet to encounter a 'perfect' company; one showing no room for improvement. Whenever we review a new candidate, we also identify any areas of weakness where we want to engage with the company. This is then coordinated with the Sustainable Investment Team, with all interactions and outcomes recorded for auditing and reporting purposes.

As well as improving outcomes for shareholders and stakeholders, we believe engagement reduces the risk of being blindsided by a controversy, as we have a good understanding of where our holdings' weaknesses lie and can manage our position sizes or divest if we feel they are not being appropriately managed.

Conclusion

Investors are increasingly concerned with the impact of their investments on society, leading to strong and growing demand for ESG/SRI products. With more and more concerns about income inequality and questions being raised about whether capitalism in its current form is delivering for shareholders at the expense of broader society, we expect demand for investments that can deliver both shareholder and societal value to continue growing.

The 'inconvenient truth' is that incorporating ESG factors within a portfolio is not easily achieved through simplistic screens and passive approaches. It requires thoughtful and thorough analysis that focuses on a company's genuine commitment to ESG rather than mere policy disclosure. Detailed forward-looking fundamental analysis is required to avoid the pitfalls of 'greenwashing' and box–ticking, and to identify 'good' companies that are also good long-term investments.

We believe that a broad-based stakeholder approach combined with targeted, proactive engagement is the best way to raise corporate standards for the benefit of society, while still delivering scalable alpha and managing downside risk for our investors. We believe there is no trade-off between shareholder and wider societal value. Ultimately, good corporate citizenship is an important driver of long-term alpha generation.

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