GEM EQUITIES INSIGHT

Assessing Sustainability: Kicking Tires, Not Ticking Boxes

October 2018

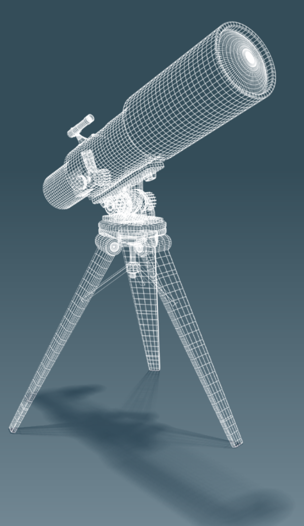
We are long-term investors with a fiduciary duty to be responsible stewards of our clients' capital. We consider this responsibility in a holistic sense. Investment returns and environmental, social and governance (ESG) concerns are not separate entities – they are intertwined.

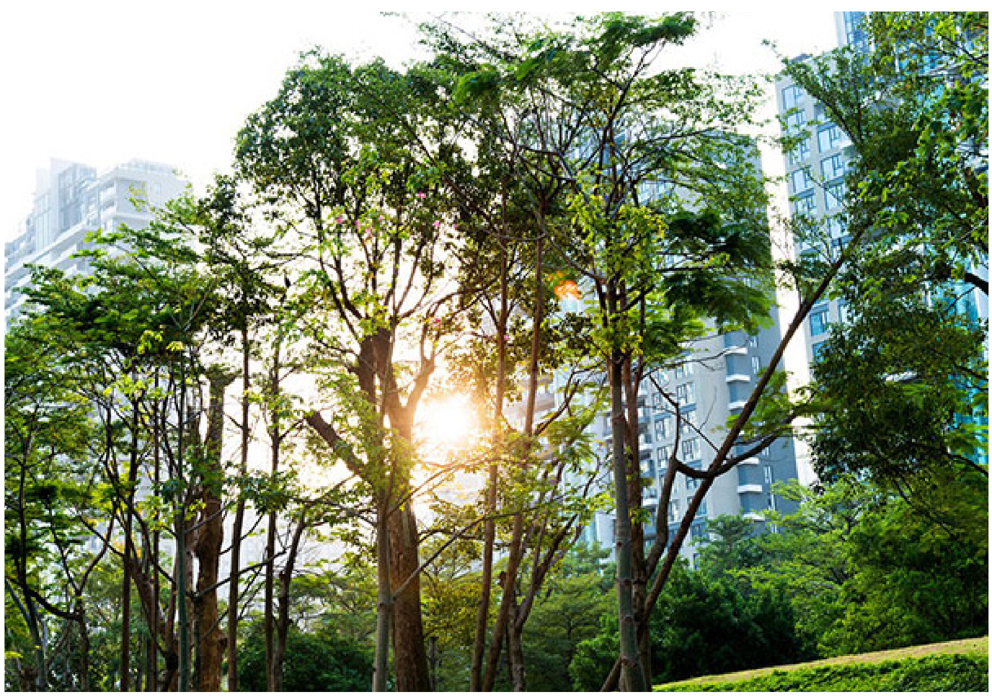
A company that abuses its customers, dumps toxic waste in a river or has questionable governance is providing a warning sign that it does not care about the long-term future of its business. That should ultimately be reflected in its valuation and long-term return potential. A business that simply seeks to improve its returns in the short term is likely to be called out when customers, or the government, respond to these abuses. It is why we are uncomfortable about following the industry trend of placing an ESG title on our strategies. Sustainability is an indivisible part of our investment philosophy and process.

Assessing Sustainability

While the history of investing with a view to influencing societal change spans many decades, arguably, the term "ESG investing" was first devised in 2005 in a landmark report called "Who Cares Wins." It was initiated by a former U.N. secretary-general as part of the U.N. Global Compact in collaboration with the International Finance Corporation and the Swiss government. Since that time, attitudes toward the provision of ESG-related information by companies have changed dramatically.

As reported by Forbes, 80% of the world's largest corporations use Global Reporting Initiative (GRI) standards. Emerging markets companies were initially seen to be lagging in this regard, but standards have improved. The need for developing economies to attract equity capital has seen exchanges that set the tone for corporate governance and reporting. Evidence for this can been seen in a recent Financial Times article (May 2018) that stated, "...of the 38 stock exchanges that produce guidance to listed companies on ESG reporting – 22 are in emerging markets. South Africa's so-called King IV corporate governance code is widely cited as an example of best practice."[1]





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Janus Henderson
INVESTORS

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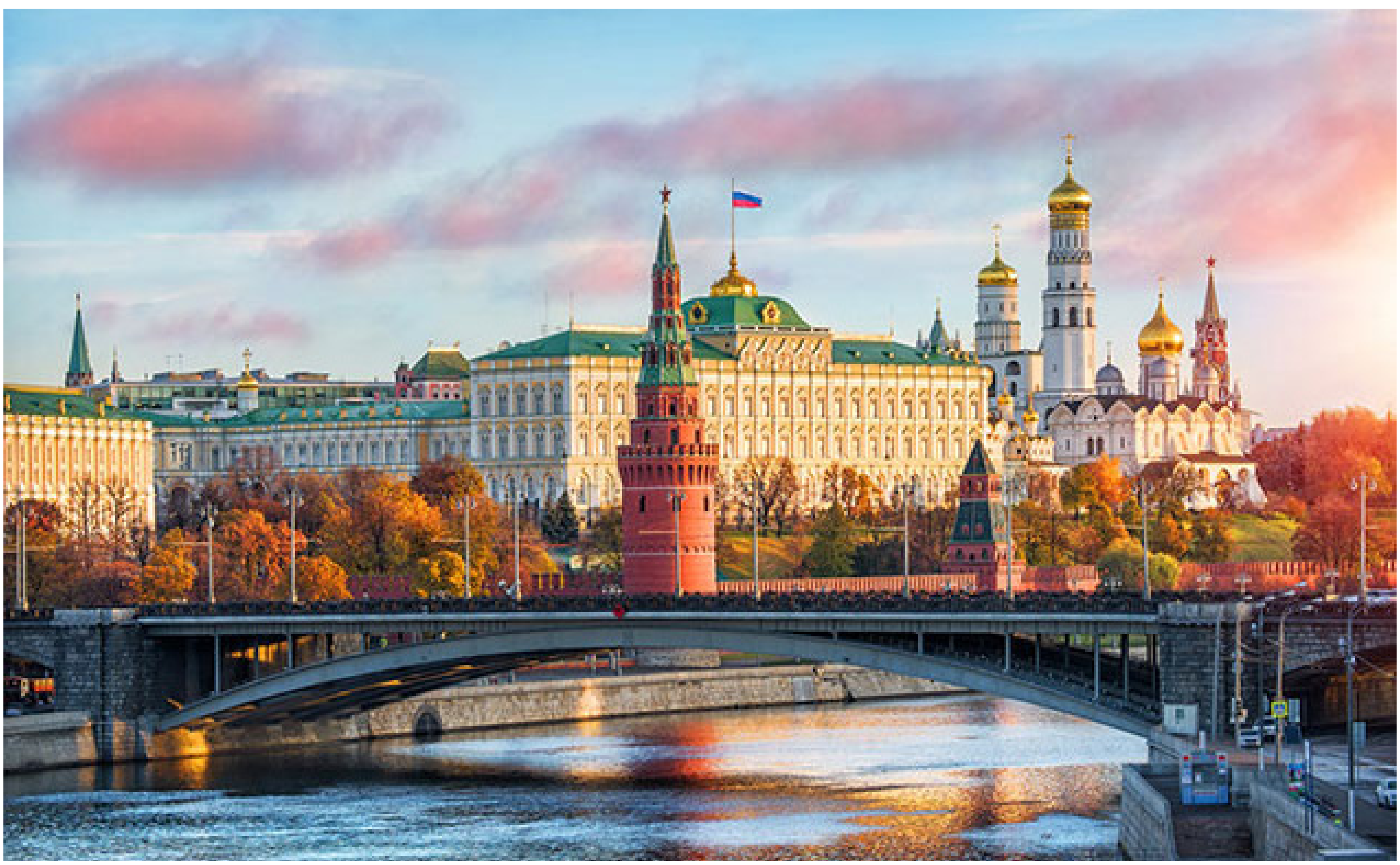
The natural human response to this avalanche of ESG data is to quantify, simplify and compare. This can be seen through the numerous providers of standardized ESG metrics utilizing "big data" to crunch the numbers. While useful in part, our preference when assessing sustainability is to focus less on the "what" and more on the "why." The disclosure of a policy or quantitative metrics will not necessarily reduce risk unless the governance structure and culture of the institution are aligned. Policies are easy to disclose but a lot more difficult to embrace.

Just Because Something Can Be Measured Does Not Mean It Provides a Valuable Signal

The problems associated with a data-centric approach to assessing sustainability factors can be seen in Russia. We do not currently have any Russian companies on our proprietary watch list, as we cannot currently find businesses of sufficient quality. The kleptocratic business environment also poses significant challenges to minority investors. A casual reading of Bill Browder's book, "Red Notice," gives legitimacy to the notion that minority investors may not receive significant protection from the Russian judicial system.

It is within such a context that one should cynically consider the recent sale of a 29% stake in Magnit by its founder, Sergey Galitskiy, to Russia's second-largest state bank, VTB. The 29% level is important because it allowed VTB to evade the 30% takeover threshold, at which an offer to all minority shareholders was legally required. Less than three months later, VTB announced that it had sold 12% of its stake in Magnit to Marathon Group, owned by Alexander Vinokurov (who is the son-in-law of Russia's current foreign minister) and Sergey Zakharov. With the sale not occurring between the two private parties directly, it would appear that the State has been able and willing to involve itself in the redistribution of a large equity stake in a leading retailer. Such a transaction casts significant doubts in our minds about corporate governance standards and protection for minority equity investors in Russia.

With the above in mind, one may be surprised that in the World Bank's "Doing Business 2018" report, Russia ranks 35th, immediately below the Netherlands, Switzerland and Japan, in that order. That is because the annual ranking of business friendliness of regulatory systems is not based on a qualitative assessment of business surveys. It analyses regulations and regulatory change and gives points for pro-business measures and takes them away for anti-business practices. As the Financial Times acknowledged in 2015 when commenting on that year's report, "In many ways it favors authoritarian regimes with the capacity to pass regulations quickly through rubber-stamp parliaments over democratically elected ones. It also appears to put a premium on laws as they are written rather than how they are enforced."[2] It is a good example of the risks associated with putting significant faith in a score-based system of evaluation.



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Greenwashing

The limitations and risks of assessing sustainability using a purely data-centric and scoring-based system can also be seen with the ESG ratings industry. More data can help improve transparency and the evaluation of these risks. It can also allow poor management teams to hide behind a wall of data. The American Council for Capital Formation highlights this issue in a report titled "Ratings that Don't Rate: The Subjective World of ESG Ratings Agencies." "In general, ESG rating systems reward companies with more disclosures. It is possible for companies with historically weak ESG practices, but robust disclosure, to score in line with or above peers despite having more overall ESG risk."[3] Some high scores may reflect a company's marketing program and disclosure efforts rather than its true commitment to ESG and sustainability. Greenwashing refers to a company or organization that spends more time and money claiming to be "green" through advertising, marketing or disclosures compared to actually implementing business practices to minimize negative ESG impact. It is the embodiment of Goodhart's law: "When a measure becomes a target, it ceases to be a good measure."

The Value of Engagement

We are looking for corporate owners and management teams that practice what they preach. It is why we aim to look beyond the glossy sustainability report and discuss with the leaders of a business how they view their specific sustainability challenges. Good management teams should be continually assessing the threats that their businesses face – be it competitive, industry, societal or environmental. Doing so leads to a different style of interaction with management. It also helps to build relationships, as good management teams understand that our interests are broader than simply trading paper.

We look to engage with management to discuss topics directly related to the investment case. This might include everything from strategy, capital management and board composition to remuneration, environmental impact and reputational risk. We have found that these kinds of engagement help to build conviction in the broader investment case. It also provides a way to see different sides of a management team and their understanding of risk in a broad sense. In addition to ensuring a company has a good record of corporate governance, the research process endeavors to understand the company's community relations and approach to environmental challenges. The market tends to underestimate how often these types of non-financial risks become real financial losses, particularly within emerging economies with immature legal and political systems.

Active Listening

As active investors focused on delivering long-term returns, we have to be good stewards of our clients' capital. Directing capital toward productive and responsible investments brings with it a responsibility to engage, inquire and influence where necessary. It also requires us to listen. Carl Rogers and Richard Farson coined the term "active listening" in an academic paper in 1957, which was reprinted in the volume Communication in Business Today. They wrote, "Active listening is an important way to bring about change in people. Despite the popular notion that listening is a passive approach, clinical and research evidence clearly shows that sensitive listening is a most effective agent for ... change."[4]

We also recognize the importance of humility, both when communicating with management teams and when assessing any long-term impact of our interactions. High-quality management teams are naturally incentivized to lead businesses in the right direction over the long term.

Our experience of interacting with Cairn Energy, is illustrative of this. Cairn Energy had been working with a joint venture partner (Kosmos Energy) on an offshore exploration block off the Western Saharan coast. This resource was claimed by both indigenous tribes and the Moroccan government, and we had doubts as to whether the political situation would ever allow this to be a profitable or realizable resource. We maintained an ongoing dialogue with senior management regarding the potential reputational risk of these activities, given the sensitivity around Moroccan influence in Western Sahara. The company has listened to these concerns and to others who have been engaging more vociferously on this subject. They assured us that they would carefully weigh the potential risk against any possible gains they perceive the region may offer. In March of this year, the company announced that it had relinquished its rights in this area, as the realizable value of the resource was questionable, in both financial and reputational concerns.

A Need for Humility

It would be easy for us to simply state that our engagement led to this outcome – but the truth is probably more complex. We are likely to be one of many voices that the management team hears. It is why looking for beneficial alignment between management and us is so important to our investment philosophy and process. By being consistent, thoughtful and focused on the long term, however, we put ourselves in a strong position to encourage management teams to operate in a sustainable manner for the benefit of all. Our quarterly review of ESG engagement in this document includes a final column that acknowledges outcomes. It is with the spirit of the above in mind that this rather black-and-white representation should be seen.

We believe that the distinction between ESG and investment philosophy and process is an arbitrary one. Ultimately, all these factors feed into the consideration of the quality of a business and the sustainability of a forward-looking basis for its franchise. To that end, it should not be a surprise that we follow the same approach to assessing sustainability as we do when looking at other aspects of a business. We prefer to "kick the tires," rather than "ticking boxes." The creation of long-term investment returns is, by its very nature, investing in sustainability.

[1] The Financial Times, May 14, 2018.

[2] The Financial Times, October 27, 2015.

[3] Doyle, T. "Ratings that Don't Rate: The Subjective World of ESG Ratings Agencies." American Council for Capital Formation, 2018.

[4] Rogers, Carl and Farson, Richard E. "Active Listening." University of Chicago Industrial Relations Center, 1957.

Janus Henderson
INVESTORS

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