ENLIGHTENED SELF-INTEREST

PERSPECTIVES ON ESG

First Quarter 2017

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ENLIGHTENED SELF-INTEREST

We want the world to be a better place. We would be delighted to play a part in making it so. Nevertheless, this is not the primary driver for us to seriously consider ESG issues, nor do we think it is the most effective reason to consider such factors. Put bluntly, we consider such factors because we believe it to be in our own long-term self-interest and that of our clients. We believe that the greatest long-term investments will be in those companies that deliver the greatest positive impact for humanity. The founder of Alibaba, one of only a handful of people alive to have created a company worth more than $250 billion is explicit in this view:

> *"Today, if you want to be a great company, think about what social problem you could solve."*

JACK MA, FOUNDER OF ALIBABA (2014)

To us, it is both intuitive and logical that good companies with a positive impact will become more valuable. Likewise, it seems logical that companies with powerful negative externalities are not sustainable businesses. Big oil companies will become marginalised because their impacts are so harmful that they have to be disrupted through investment and the prioritising of renewable energy. On a five to ten year time horizon we struggle to see how they can be attractive investments.

We would also argue that the link between a company's long-term success and its impact on the environment and society is increasing. This is because the feedback loop seems to be getting stronger. The internet allows information to be shared quickly and easily, which makes company practices, good or bad, much more visible. Just as importantly, we believe the pace of technological change is accelerating, allowing those companies with harmful externalities to be challenged and disrupted faster.

The idea that enlightened self-interest can be an effective way to serve society is not new. Adam Smith made a similar observation almost 250 years ago:

"By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it."

ADAM SMITH, WEALTH OF NATIONS (1776)

FLAWED CAPITALISM

The immediate response to the above should rightly be cynicism. Economic theories, particularly those espousing perfect systems, rarely hold up in the face of reality. If serious incorporation of ESG factors delivers better financial returns, then why do investors not make it a more integral and genuine part of their investment process? More important still, if a company's impact on society and the environment influences long-term financial success, then why do big oil, big pharma and big tobacco still garner market values in the hundreds of billions of dollars?

The simple answer is because markets are terribly inefficient. Foremost among these inefficiencies is short-termism. So often economists view investors as perfectly rational market participants when we are not. The economist Alfred Marshall was right to observe that people sometimes act like "children who pick the plums out of their pudding to eat them at once" or as Arthur Pigou noted we possess a 'defective telescopic faculty' such that 'we see future pleasures on a diminished scale'. In the fund management industry, institutional structures heighten this behavioural flaw several fold through agency issues, short-term measurements and misaligned incentives. That our industry then has the gall to trumpet to others the importance of good corporate governance is of course the epitome of hypocrisy.

Andy Haldane, the Bank of England's Chief Economist, has criticised hyperbolic discounting in financial markets: five year cash-flows are routinely discounted as if they were eight years out, and cash-flows 30 years out are scarcely valued at all. More worryingly, when chief investment officers of the world's top asset management companies were asked about their time horizon, 55% responded that it was a single quarter or less. A mere 20% responded that it was a year or more.

Given the above it quickly becomes obvious why the societal and environmental impacts of a company are not taken into account. They are not relevant to most market participants. Oil should be replaced and disrupted by the falling cost of renewables leaving much of their reserves worthless. But this will happen in many years, not by the end of the next quarter. The oil price could easily surge in the next year, even if it does become near worthless by 2030. Unless an investor has at least a five-year time horizon, we don't think ESG factors will truly matter to them.

It is only when considering investments on a five to ten year time horizon that many of the positive and negative impacts on society start to matter. Leading technology companies such as Amazon, Facebook and Google have rightly been lambasted for failing to pay adequate taxes in many of the countries in which they operate. For the market participant owning the shares for a quarter or even a year, this is a benefit as it boosts immediate profits. For us, it is a cause for concern. Not only are such low tax rates unsustainable, but they risk damaging incredibly valuable brands and encouraging society and governments to pursue more stringent regulation across their operations. In the long term it could cost them far more than they save. We have large holdings in such internet companies and our colleague James Anderson has publically expressed this view: "My take remains that it is in the long-term interests of Google and others of that ilk to pay decent rates of tax and that they and others would be best served in taking the lead in volunteering this".

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JAMES ANDERSON, THE TIMES OF LONDON (2016)

MORE THAN YOU CAN MEASURE

We think genuine incorporation of ESG factors requires you to analyse more than what can be easily measured or is voluntarily disclosed in a company's annual report. This presents a further challenge to an industry that thrives on quantitative measures and the quest for certainty.

Rankings and analysis done by the likes of Corporate Knights and Sustainalytics have done well to promote the importance of ESG. Nevertheless, they also produce odd results because the measurable is greatly prioritised over the immeasurable, resulting in a narrow and constrained approach.

To give an example, Sustainalytics scores Tesla well below its peers BMW, Renault and Peugeot on environmental impact. This isn't because it doesn't believe in the potential electric and solar revolution, but largely because Tesla doesn't have a formal environmental policy or significant environmental disclosure like its larger fossil-fuel based peers. The outcome of this goes against common sense. A company that has the potential to transform our lives by de-carbonising transportation and electricity should not rank below those that support the inherently unsustainable carbon economy.

We need to remember that measurability is not directly linked to value. Just because something can be measured does not mean it is useful or insightful, and just because it cannot be measured does not mean it is devoid of value.

"the overarching purpose of Tesla Motors is to help expedite the move from a mine-and-burn hydrocarbon economy towards a solar electric economy, which I believe to be the primary, but not exclusive, sustainable solution."

ELON MUSK, THE SECRET TESLA MOTORS MASTER PLAN (2006)

The Tesla Gigafactory is shown under construction outside Reno, Nevada.
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HOW WE APPROACH ESG FACTORS

We incorporate a company's governance, as well as its impact on the environment and society into our research framework by asking whether the company makes the world a better place. This question is intentionally broad and qualitative. This approach allows us to tailor our analysis and to focus on context, and the long-term impact of a company's vision, approach and actions.

Findings from this question can then be used as inputs into our scenario analysis of what a company may look like in the next decade. It has a direct impact on how we think about the probability-weighted value of companies, which in turn filters through to our portfolio construction. Companies that are harmful to society and the environment are assigned lower probabilities of success or shorter duration market opportunities. It is for this reason that the portfolio does not hold oil, tobacco or traditional big pharma companies. We don't have an ethical ban or restriction: instead, we simply don't have conviction that these should be valuable companies in the long term owing to their negative externalities.

The reverse is also true. We think ASML is immensely valuable because the technological progress of humanity is inextricably linked to its ever improving machines which are required to sustain Moore's law. We think that Mobileye's market opportunity is large because automated vehicles will address so many inefficiencies in the use of human capital, from time wasted on journeys to lives lost in fatal accidents. We think that healthcare holdings such as Sysmex and Genmab matter because they are genuinely aspiring to improve the lives of cancer sufferers rather than simply pursuing a larger bottom line.

We focus particular time on those companies where we think we have a difference of view. Perhaps controversially, we think Alibaba, Baidu and Tencent will succeed because they have impacts, which, on the whole, are hugely positive for society. In the case of Alibaba, it is helping the Chinese economy rebalance to consumption by providing a leapfrog in retail and finance infrastructure. In the case of all three, we think their technology and platforms inherently further freedom of information and speech within a restricted system. They present the Chinese Communist Party with its greatest challenge – to adapt to an increasingly connected and informed society.

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FINAL THOUGHTS

As long-term investors we think it would be foolish to ignore the impacts our companies have on societies and the environment. We view it as in our clients' financial interest to think deeply about these issues.

The inefficiencies of incorporating ESG into investment analysis and market valuations are unfortunate but we think they also provide us with three key advantages.

— First, our five to ten year time horizon means that ESG factors really matter to our investment success. This provides a genuine incentive to pursue this seriously.

— Secondly, many of the issues are highly qualitative in nature and do not lend themselves to easy measurement. Fortunately, as an investment firm we are already qualitative in our investment approach, a reflection of the long investment horizon we take. We think this more qualitative approach is better suited to the nature of ESG issues.

— Finally, we combine ESG as an integral part of our research framework rather than as an additional activity. We think this allows ESG issues to be directly linked to the probability-weighted valuations that we apply to companies, and therefore for these considerations to influence portfolio construction.

As ever, the need to improve remains, whether through talking to ethics professors, meeting management teams or learning from stakeholders. This work is in both our self-interest and yours.

CURIOUS ABOUT THE WORLD

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