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A CONVERSATION ON E.S.G. WITH A CIO

Why should a fundamental manager care about E.S.G.?

Firstly, let's agree on some definitions on SRI and ESG, as they are sometimes used interchangeably and may be understood differently – or confused.

ESG (environmental, social, and governance) represents the three core factors behind sustainable and responsible investing. Sustainability is a result of managing the challenges and risks which face all organisations in meeting the needs of the present, without compromising the needs of future generations.

We are long-term, global investors, acting in the best interests of our clients. We believe that one cannot claim to be a good fiduciary, mandated to create and preserve long-term wealth, while ignoring the principles of sustainable and responsible investing. Because of this relationship between responsible investing and fiduciary responsibility, Nikko AM signed the UN PRI (Principles for Responsible Investing) in 2007, the year of its formation.

Socially Responsible Investment ("SRI"), Impact Investment, and ESG are slightly different, even though they all share similar tools. SRI and Impact Investing are intended to address certain macro impacts (e.g. climate change) through the investment of one's capital. Here the investment objectives derive from an investor's beliefs and values to accomplish a positive change in society. When a client directs us to do so, we can offer investment strategies designed to provide positive impacts, for example, for a better environment through green bonds and ecosystem-focused investing, or investment strategies that include the negative screening of certain sectors.

ESG, or responsible investing, is much more fundamental. We see it as inherent to long-term value creation, and therefore incorporating ESG in our investment process is completely consistent with, and integral to, fulfilling our fiduciary responsibility.

Let's get a little more granular

Governance: It's safe to say, in my opinion, that good governance forms the bedrock of value creation. Good governance is good business. This connection is common sense and is deeply rooted in the principal-agent theory in economics. Separation of ownership and control is arguably one of the best developments of modern capitalism, enabling the pooling of capital from diverse investors. It has, however, also led to issues of accountability and control of management. Considerations such as executive compensation, defining a board's duties, transparency and disclosure are important elements in framing the oversight of company management for the long-term interest of the owners. The mentality of long-term owners about good corporate governance is quite different to that of a shareholder who trades in and out of a stock, or as part of a passive strategy. As such, engaging company management on long-term issues becomes natural and necessary in order to understand the executives' beliefs, strategy and execution, and evaluate corporate governance.

Social: Social impacts are often linked to long-term risks to enterprises and corporate valuations, which can be difficult to quantify. For example: Social factors, such as the relationship between labour and product safety, human rights violations and child labour abuse. To identify risk factors such as these requires a good understanding of the micro issues of a company's operations including: manufacturing and vendor practices, marketing and selling practices, internal morale and employee turnover. While not financial metrics per se, they are all inherently tied to an assessment of a company's quality. By understanding how a company deals with social factors, and the relationships between the various stakeholders (management, labour, suppliers, clients, shareholders, board and the broader community), a long-term investor can better identify the risks or potential for disastrous financial or reputational results.

Environmental: The environmental factor often exists as an externality cost (e.g. climate change, pollution, resource depletion), which companies and analysts may ignore because of the extent of the issue and its global nature. Environmental issues ultimately do matter to investors because externality costs are eventually borne by all of society. For very large investors, the concept of Universal Ownership compels them to explicitly recognise all externalities as costs generated by one company borne by other parts of the economy; ultimately affecting the investor (and all of their investments). Some examples include: carbon pricing; pollution and water regulations; the Fukushima disaster's cost on Japan's energy policy; etc. While each company may bear a small portion of the total cost, losing sight of the total cost would miss one of the key drivers of a company's potential liability.

The elegant simplicity and consistency of this perspective is that ESG and good investing are two sides of the same coin. Investing in a quality company requires good financial and ESG analysis to understand the total enterprise. Let's look at the truth of the connection between ESG and value creation.

Some say the connection comes from performance, i.e. better ESG companies create more value. Some say the connection comes from the risks of bad ESG, which leads to value destruction. Some say there are many opportunities for companies to exploit by assisting to solve the problems of society. Others might quietly point to peer pressure and to an industry-wide chorus for compliance versus risking losing institutional business. These answers, while arguably all true, are not necessarily complete and may contain a degree of cynicism.

If we replace "ESG" with "speak the truth" or "honesty", do we act truthfully to earn trust because it leads to better performance, avoid value destruction, and retain business? No. We do it because it's the right thing to do. In the same vein, ESG is the right thing to do.

An analogy can be drawn between the above, and a good risk management and compliance culture. Our investment solutions are consistent with good risk management and good compliance, but we don't label them as such. In the same vein, while we employ teams of risk and compliance specialists to support these important functions, the fund manager still owns and cannot delegate these basic responsibilities.

That's why, in our view, it's less important to establish empirical proof that practicing ESG leads to positive outperformance, than to simply incorporate it into our processes and know that the Principles for Responsible Investing underpin all that we do. Demanding an explicit and proven financial reward for doing something that's fundamentally the right thing to do is to under-appreciate the value of doing the right thing in the first place.

Nikko Asset Management's approach

Our best current thinking is that the implementation of ESG is an on-going journey, rather than a one-time event. First and foremost, our managers share the beliefs and we practice what we preach. As one of the first signatories to the PRI, we have pledged to adhere to the six stated principles, which also form the core of our own Policy Statement. Our behaviour is consistent with our words.

Lastly, our focus should be on continual integration of those principles and best practices into our investment processes. Sustainable and responsible investing is no longer a niche sector. ESG is mainstream investing, consistent with and integral to being a good fiduciary. All of our investment strategies bear the ESG seal of quality standard. Certain clients want ESG-focused strategies, which for us are little different to our main strategies, as they all are ESG-focused. There will also be clients who want to focus on certain factors or achieve certain social outcomes with their investment capital. For these opportunities, we tailor investment solutions, either active or passive, from our global investment teams' capabilities.

Many institutions are looking for an ESG stamp of approval from their assets and asset managers, because their constituents are pressuring the investment boards to be "good" capitalists. As long-term owners of enterprises, we believe that ESG is well supported by sound economic theories (e.g. principal-agency and externalities) and that being a good capitalist actually turns out to be good business.

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