

Market Musings 10/25

For Professional Investors only



The wind of change for equity investors

Why staying the course on ESG continues to add value

Over the past decade, ESG has moved from the periphery to the mainstream, with investors launching funds and strategies branded a 'Green', 'Sustainable' or 'ESG-focused'. Investor enthusiasm peaked in 2021 and 2022, driving valuations of companies tied to the green transition to record highs. Luc Plouvier, senior portfolio manager for our Global Dividend strategy explains that the tide has turned.

Recent quarters have seen a marked shift from inflows to outflows in ESG-related investment funds, which is a clear signal that popularity is waning. Some of the former ESG-darlings have struggled to meet lofty expectations, facing project delays, capital shortfalls, and disappointing returns. The ESG pendulum has swung from exuberance to growing skepticism. In this edition of 'Market Musings', we would like to highlight our approach towards ESG. We expect that this approach will continue to add value to the portfolio.

Remaining steadfast in ESG

While some investors have moved from one extreme to the other – first embracing ESG uncritically, then rejecting it wholesale – we continue to believe that a thoughtful, integrated approach remains the most effective approach. ESG is not a trend to be followed or abandoned based on sentiment; it is a framework for understanding long-term risks and opportunities. By embedding ESG into our investment process, we aim to enhance portfolio resilience, identify emerging growth drivers, and contribute to a more sustainable economy. Our philosophy has remained consistent: ESG is vital, but it must be approached with balance and consideration, rather than extremes.

Our approach to ESG: pragmatism and analytical rigor

Our approach to ESG is grounded in pragmatism and analytical rigor. We prefer inclusion over exclusion, recognising that engagement with companies is often more effective than divestment in driving meaningful change. We don't rely solely on ESG scores; instead, we conduct our own assessments, informed by direct dialogue with management, sector-specific insights, and a deep understanding of materiality. This approach enables us to identify the risks and opportunities that go with ESG, while avoiding conclusions based on superfluous observations.

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Selective exclusions based on principles

Although we prefer inclusion over exclusion, in specific cases we consider the ESG issues too severe, and limited scope for improvement makes investment unjustifiable. Companies involved in the production of controversial weapons – such as anti-personnel mines, cluster munitions, chemical and biological weapons, and nuclear weapons – are directly excluded from our investment universe. In addition to controversial weapons, we avoid companies that structurally violate international conventions and have demonstrated no improvement over the years. Tobacco is also excluded, based on a principle-based decision framework that considers the harmful outcomes related to health, economics, and the environment. We also exclude companies that are involved in coal mining and oil sands. Our exclusion criteria evolves over time. Based on new information and developments in international standards (such as the UN Global Compact Framework), we are regularly updating our exclusion criteria. For certain client-specific mandates, we apply additional exclusion criteria.

ESG integration embedded in investment decisions

ESG integration is at the heart of our investment approach. We assess the ESG profile of each company on a case-by-case basis, considering material risks in a given industry, the company's respective risk exposure, practices, disclosure, and exposure to past controversies and future ESG opportunities. Based on our fundamental ESG analysis, we form an opinion on the quality of a company's ESG profile and award each company a proprietary ESG risk score. The ESG score feeds into our risk assessment of the company and our valuation. We actively engage with companies that score poorly, with the aim to reduce ESG risk over time and to unlock long-term value.

We rely on data from third-party ESG advisers as well as company-reported data, but our final assessment is always internal. Differences between ESG ratings providers often prompt us to engage with companies to improve their disclosure.

Driving meaningful change through engagement

Engagement is where big differences can be made. Our engagement process defines clear objectives, with progress and results tracked and documented. We closely monitor the progress that companies are making and continuously use our influence to improve their ESG performance. Engagement can start at any of four milestones: raising concern with the company, company acknowledgment of the issue, company setting out a strategy or agreeing to improve, and company implementing the strategy. When the fourth milestone is reached, the engagement is closed, and we continue to monitor the company's progress.

One current example is our engagement with our investments in South Korea. We invest in insurance and banking groups. For many years, the shares were trading on low multiples of earnings and book value. One of the important reasons was that the companies only returned a fraction of their earnings through dividend or share repurchases. The low payout ratio negatively impacted external ESG ratings, because it signaled weak corporate governance. By engaging with the companies, our investees have created plans to increase the shareholder distributions. As a result, the shares have materially re-rated. This example underlines that engagement, rather than exclusion, is often the most effective way to address ESG risks and opportunities.

Conclusion: Staying the course on ESG

The current ESG backlash underscores the importance of maintaining discipline, conducting thorough analysis, and avoiding simplistic narratives.

While some investors have moved their ESG attitude from one extreme to the other, we remain convinced that a thoughtful, integrated approach is the most effective path forward. ESG is not a trend to be followed or abandoned based on sentiment; it is a framework for understanding long-term risks and opportunities. By embedding ESG into our investment process, and preferring engagement over exclusion, we can continue to add value to our portfolios.

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The value of your investment may fluctuate, past performance is no guarantee for the future. Do not take unnecessary risks. Before you invest, it is important that you are aware of and are informed about the characteristics and risks of investing. This information can be found in the available documents of the strategy and/or in the agreements that are part of the service you choose or have chosen.



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