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The Role of Responsible Investing in Active Equity Management

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At Epoch Investment Partners, we continually broaden our research lens to ensure that all relevant factors are built into our investment process. Our investment philosophy centers on two principles: 1) that the value of any business is driven by the cash flow it generates, and 2) that increases and decreases in value are determined by management's skill in allocating free cash flow (defined as the cash available for distribution to shareholders, after planned capital expenditures and cash taxes). Further, when a firm consistently earns returns above its cost of capital, the result is a financially sustainable business model.

This note sets out why Epoch believes that Environmental, Social, and Governance factors, or "ESG," are a useful adjunct to our traditional fundamental research and portfolio construction practices, and a valuable tool for investors generally.

What is ESG Investing?

The ESG considerations that large corporations face are many and complex, and their meaning and importance varies among investors. Asset owners have become increasingly interested in ESG in recent years, but it is not a new idea: Investment on social principles can be traced to 18th century England and John Wesley, the father of the Methodist movement.

Several forces in today's economy and society are leading more investors to consider ESG issues in their investing. These include concerns about a short-term management focus, among both corporations and asset managers; demographic trends; shifting consumer preferences; and improved communication and networking via social media. Moreover, gender equality, diversity, and the implications of climate change have also become top-of-mind considerations.

These and other concerns were given formal expression at the global level in the 17 Sustainable Development Goals agreed to in 2015. The Paris Agreement of 2015 further highlighted global consensus on the need for aggressive action to limit climate change. At the time, estimates of the investment needed to counter global environmental damage reached $5 trillion to $7 trillion. The critical conclusion arising from the Paris Agreement was that global governments alone would not have sufficient resources to deal with the threats from climate change and related issues.

Instead, a partnership among governments and the private sector would be necessary to meet the Paris Agreement's goals, with crucial roles for asset owners and investment managers. The effort calls for encouraging responsible business prac-

tices, and effectively managing capital by identifying risks such as potentially stranded assets, as well as new growth opportunities from the transition to a lower carbon economy. And investors have stepped up to the challenge: Data from the United Nations Principles for Responsible Investment suggest that total assets managed with some reference to ESG considerations exceed $70 trillion, and with additional rapid growth to follow.

Integrating such factors into investing processes is increasingly important. The table below shows the characteristics of various approaches to ESG, and how Epoch's investment process fits in.

Incorporating ESG

At Epoch, our primary mission is to deliver superior risk-adjusted returns to our clients. Our research process identifies the material financial and non-financial factors that drive companies' revenue and earnings, and in turn their stock market performance. We believe that broader governance, social and environmental issues may take on greater importance in the future. As a result, it is essential that we continue to expand our investment scope to ensure that we include the right factors in our security selection, and that we emphasize them in our interactions with company managements.

Epoch's view is that ESG insights can provide company managements with a broader framework for realizing a lower cost of capital, and more sustainable cash flows for the longer term—achievements which are good for business, good for shareholders, and good for society in general. Academic researchers and investment managers have conducted many studies of the investment returns of ESG strategies, and while the results vary by time frame and methodology, in general, ESG can be additive to risk-adjusted returns, or at least "does no harm." A small set of those studies is noted in the appendix at the end of this piece.

The "G" component of ESG, governance, has historically been viewed as the most important. This makes sense, as companies are led from the top down, so that poor governance is likely to lead to poor decisions over time, and in turn poor outcomes. Given the key role of governance—which goes beyond purely financial considerations—company managements may be able to draw valuable insights by bringing all stakeholders throughout a firm's value chain into decision processes.

FIGURE 1: A Framework for Comparing ESG Strategies

Investment Approach	Key Considerations	
Exclusionary Screening	Exclusions based on nonalignment with global standards or investors' moral values	Moral or ethical values
Positive Screening	Bias toward: • "Best-in-class" companies on ESG measures • Companies with strong ESG momentum • Companies solving specific ESG themes	Overweight "doing good"
Active Ownership/Stewardship	Voting company shares and engaging with companies on certain ESG issues to potentially effect change in behavior or company practices and policies	Influence company strategy for value creation Growth of passive
Impact Investing	Targets a measurable positive social and/or environmental impact. Investments are generally target specific.	Philanthropic
ESG Integration	Incorporates ESG data, alongside traditional financial analysis, into the securities selection process.	Mitigate ESG Risks Regulation Millennials
The Epoch Approach	ESG Integration/Stewardship	Mitigate ESG Risks Identify ESG Growth opportunities

Source: Epoch and SSGA, "Understanding and Comparing ESG Terminology: A Practical Framework for Identifying the ESG Strategy That is Right for You," September 2017.

On environmental issues, or the "E" factor, climate change has become the most important consideration, and been placed in the spotlight following the publication of an alarming report in August 2019 by the Intergovernmental Panel on Climate Change (IPCC). The IPCC concludes that humanity must keep greenhouse gas emissions within the limits of the Paris Accord, or risk a potentially devastating global outcome.

Investors should understand two key points on the environment: First, the impact of business practices on the environment, and second, the effect of the environment on companies' ability to do business. Companies are increasingly under scrutiny as to whether they have policies in place to allow them to meet the goals of the Paris Agreement (which calls for maintaining a global average temperature of less than 2° Celsius above pre-industrial age levels, and desirably less than 1.5° C).

Companies producing fossil fuels are clearly at the greatest risk: Depending upon what strategies they follow, many could face a massive problem in stranded assets. Other carbon-intensive industries are also at great risk. These concerns are bound to increase in coming years, as holding to a 1.5° C increase depends on a radical overhaul of these industries, and the application of carbon capture technologies. Unfortunately, these are early in their development, and appear unlikely to have the desired effect—likely bringing even more disruption to the carbon producers.

Equally important is an understanding of the impact from climate change on businesses of all sorts. Certain geographic locations will become inhospitable for installing plants and equipment. Supply chains could be severely disrupted. Already evident are the direct results of climate change on insurance company and bank practices: Insurers are stepping back from covering certain sectors of the extractive industries, and banks are directing more flows to "green" projects. These potential changes are not all negative, however: Many growth opportunities will arise as the planet adjusts to a lower carbon future. For investors, the good news investors is that more precise tools and reporting have been developed to assess both risk and opportunities from climate change.

Finally, what of the "S," or social issues, in the ESG framework? Much of the initial interest in social concerns was generated in the 1960s and 1970s, but it gained interest from initiatives of the World Health Organization and United Nations. Today, there are a plethora of frameworks and criteria for measuring company performance on social criteria, which should expand its importance to investment research. These issues quickly take on a high profile, and create operational, legal, reputational and financial risks for companies, and corresponding risks for investors—as in the case of Uber, which has been criticized for undercutting employment rights. Moreover, retention of top talent and high employee satisfaction could take on greater importance in a world increasingly connected by social media.

It is helpful that reporting standards generally are being improved, especially on non-financial criteria. This would include, for example, the Global Reporting Initiative and the work being undertaken by the Sustainable Accounting Standards Board. Companies are themselves a driving force in this effort, as they see the value of improved transparency in reporting their business practices: Ceres, a sustainability not-for-profit, recently published a report reviewing some 600 U.S. companies, and the evidence is clear that more and more companies are embracing the goal of sustainability.

Conclusion – ESG at Epoch

Epoch believes that making ESG insights more explicit can be a useful adjunct to traditional fundamental research and portfolio construction practices, and that the net effect should be improved risk-adjusted outcomes.

In addition, ESG policies and investing are not just altruistic. Following ESG-aware business strategies will likely improve operating efficiency, identify and mitigate risks, and potentially boost both financial performance and stock market returns.

Investing in companies that have policies and practices to maintain sustainable businesses is self-reinforcing for the longer term. Companies that produce positive cash flows can never go bust, and corporate value is created by the sensible allocation of free cash flow. While the most visible efforts may be toward decarbonization, regulations are being implemented that is forcing more explicit adherence to ESG goals across the board, for companies as well as investors.

Investment managers have acted a bit like stonemasons—rummaging through the quarry (the market place) in search of identifying interesting stones (stocks). Epoch believes that at its simplest, ESG is a meaningful and timely set of tools to help uncover those "interesting stones" to assist in building portfolios with improved risk-adjusted outcomes.

APPENDIX

1. Axioma, "ESG's Evolving Performance." 2018
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9. RBC Global Asset Management "Does Socially Responsible Investing Hurt Investment Return." 2017
10. The Economist Intelligence Unit Limited, "The cost of inaction: Recognizing the value at risk from climate change." 2015

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