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ESG integration at Ausbil: why, how and what are the benefits?

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This paper outlines why Ausbil Investment Management Limited integrates Environmental, Social and Governance (ESG) into its investment process, how we do it and what benefits it provides. In the process, the paper may also dispel some common myths about ESG. First we provide a brief introduction to our ESG framework and then examples on how ESG has been applied in practice and how that fits in with our investment philosophy.

What is ESG integration and how has it evolved over time?

Integration of ESG can mean different things to different people. To Ausbil, ESG integration ultimately means two things:

- More informed investment decisions, which can lead to better investment outcomes; and
- active ownership and engagements on ESG issues.

Occasionally, we still hear the myth that ESG and good financial returns are supposedly mutually exclusive, but that is certainly not our experience. Perhaps the myth is a leftover view from a time when the term 'responsible investment' simply equated to ethical investment, but things have evolved since then.

In ethical investments, investors might be happy to forfeit returns as long as they invested in line with their moral conviction, typically avoiding companies with exposure to tobacco, gambling or alcohol. This is also referred to as negative screening. Then came socially responsible investment (SRI), where investors were seeking out companies exhibiting positive contributions to society. This is also referred to as positive screening. Next came sustainable investment and ESG integration where investors capitalise on ESG research with the aim of driving higher returns. This is where we are today.

Better informed investment decisions and investment outcomes – what is our experience?

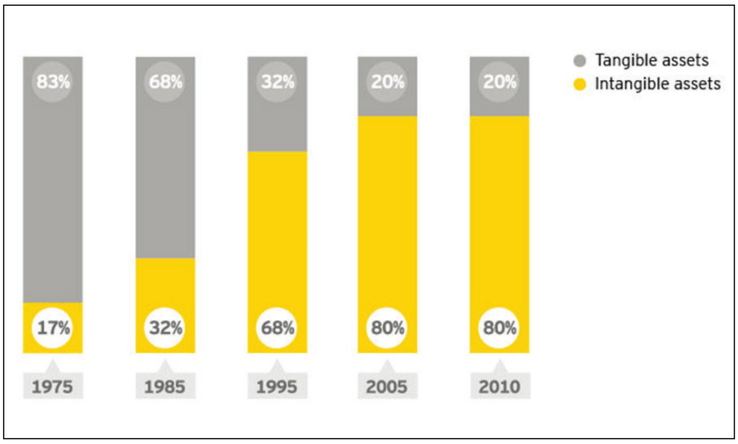
Does ESG integration contribute to better returns? There are a number of academic studies that provide support. For instance, an article published by the Australian Institute of Company Directors in 2016, said 'evidence is growing that strong ESG practices and reporting lead to better analysis of companies, more accurate valuation forecasts and higher shareholder returns over time'[1].

The article also quoted a German study called 'ESG and financial performance: aggregated evidence from more than 2,000 empirical studies', which concluded 'based on this sample, we find clear evidence for the business case for ESG investing'. While the academic literature is supportive, we prefer to look at our own experience.

For instance, as at the time of writing, about half of the short positions in Ausbil's long short strategy, the 130-30 Focus strategy, in the past 12 months have come from, or have been strongly aligned, with Ausbil's ESG research views. As a result, ESG has been an important contributor to the alpha generation of the Fund, i.e. six of the 10 best performing short positions have come from ESG research. These short positions typically refer to companies with significant corporate governance issues and/or other ESG issues.

At Ausbil, we integrate ESG research across all our portfolios and because ESG is deeply embedded into the investment process, it can sometimes be difficult to strip out the exact contribution from ESG for return analysis purposes. Nevertheless, ESG unquestionably helps us make better informed investment decisions.

To see how, let's take a step back and look at the development of intangible drivers as a percentage of a company's market capitalisation. For an average listed company, the majority of value comes from intangible drivers and this proportion has increased over time. For instance, EY found that intangible assets accounted for 17% of market capitalisation of the S&P500 in 1975, but this had risen to 80% by 2010.



Analysis by EY on the components of S&P500 market value shows that the majority of a company's value comes from intangible drivers and that the proportion of a company's value that comes from intangible drivers has increased over time.

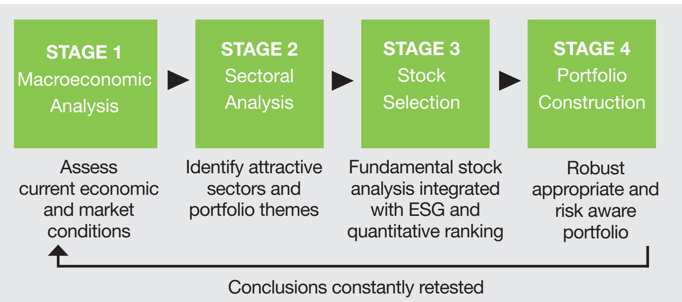
[1] 'Studies show ESG investment has solid payoff.' Australian Institute of Company Directors. 8 July 2016 http://aicd.companydirectors.com.au/advocacy/governance-leadership-centre/governance-driving-performance/studies-show-esg-investment-has-solid-payoff

What are these intangible drivers? Examples would be corporate governance, corporate culture, supplier and customer relationships, human capital developments and more. In other words, things that are highly intangible by nature, but are driving company value. These intangible drivers can broadly be categorised as environmental, social and governance, or ESG, factors and by analysing how companies are managing these drivers, we can make better informed investment decisions, including forming a view on earnings risk.

How do we integrate ESG in practice?

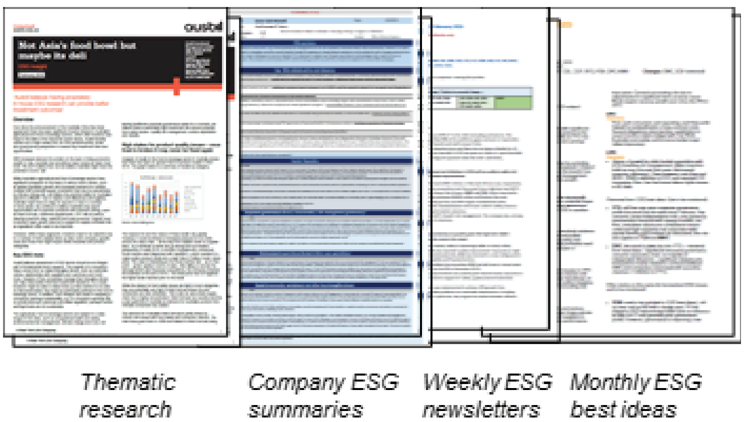
Researching intangible drivers and understanding how they impact a company can be time-consuming and complex. This is why Ausbil has decided to have a dedicated team of ESG specialists within its investment team, working closely with stock analysts. Ausbil produces its own proprietary ESG research in-house as we believe this is the optimal solution to derive unique insight.

The proprietary ESG research can feed into all four stages of Ausbil's investment decision-making process; from macroeconomic analysis (e.g. regulatory changes on climate change), sectorial analysis (e.g. changing consumer trends) and stock selection (e.g. corporate governance) to portfolio construction.



Ausbil's investment process consists of four stages, each of which can have an ESG input.

The degree that ESG research influences individual stock decisions naturally varies and different sectors are differently exposed to ESG drivers. However, all stocks under coverage have an ESG score and an ESG summary highlighting key ESG-related risks and opportunities, including potential impacts on earnings and management quality. Those outputs are direct inputs into the stock analysts' stock summaries and form part of the earnings analysis and investment recommendations.



Ausbil's proprietary ESG research includes thematic research, company ESG summaries, weekly ESG newsletters and monthly ESG updates for stock selection meetings.

As discussed above, there are many different styles within responsible investments and we don't believe there is a one-size-fits-all approach on ESG integration. However, we argue that the chosen approach must align strongly with the investment philosophy.

At Ausbil, we believe share prices are driven by earnings and earnings revisions and we prefer to invest in companies with assessable and sustainable earnings and we also prefer companies with quality management. As a result, we believe there is a natural fit for ESG integration.

- First, in regards to earnings revisions, ESG analysis can identify earnings risks before it is too late and it can assist you when forming a view on earnings versus consensus forecasts.
- Second, ESG analysis covers a wide range of factors and obviously not all of those will have a direct impact on earnings, but we believe that collectively the way a company deals with its ESG risks can tell you something about management quality.
- Third, ESG analysis can help us to assess earnings sustainability; if a company's business model relies on under-priced labour, misinformed customers, weak regulation, etc. perhaps current earnings levels are not sustainable.

What are some practical examples?

Earnings revisions

A few years ago, a company in the food and beverage sector switched to new suppliers in China for its frozen berries division. At the time, this was a major growth driver for the company and also one of the fastest growing categories for the company's customers; the supermarkets. At the time, the company's discussion and disclosure on food safety risk management in the public domain was fairly poor, which meant analysis had to rely on anecdotes. Shortly after, news emerged of people getting sick from hepatitis A and eventually, the common denominator appeared to be consumption of a particular brand of frozen berries. The company's stock plunged and, eventually, its frozen berries division was divested.

This illustrates a strong case for rigorous ESG analysis and shows how ESG issues, contrary to common belief, are not always about so-called long-term issues. As investors, we can capitalise on ESG research in the short term as well. The example also highlights the importance of investigating alternative information sources and looking beyond what companies are reporting. In ESG research, some of the best information sources include social media and not-for-profit organisations as well as independent staff reviews, which are publically available. These can provide a view on a company's culture and staff perception of the company's management as well as a company's ESG risk management in practice. For example, we proactively picked up on anecdotes of underpaid workers at one listed company, which enabled our Funds to benefit from that analysis.

Positive momentum in performance on ESG drivers can also reinforce an investment view. For instance, in the latest reporting season, we identified trends of improved staff engagement at one of our holdings in the retail sector, as part of the company's cultural transformation. In our view, improved staff engagement can lead to productivity benefits, lower costs and increased customer satisfaction, which is important in an increasingly competitive retail environment.

Other examples of ESG issues with a direct impact on earnings that Ausbil has considered, include increased consumer awareness and regulatory changes in relation to the growing obesity issue, potential costs and production disruption related to health and safety incidents and improved customer satisfaction ratings. The key to integration is to capture these risk and opportunities in earnings forecasts, while also ascertaining what is already priced in by consensus, which our earnings forecasts are compared to.

Management quality

ESG research covers a wide range of issues and naturally, not all will have a direct impact on earnings, but analysis can still provide insight. For instance, if a company is paying lip service to environmental risk management, or if a company is treating its suppliers badly, as an investor you may wonder what other issues you should also be worried about. We believe management of ESG issues can serve as a proxy for management quality. ESG analysis can also identify opportunities for engagement with corporate management on ESG issues (please see below).

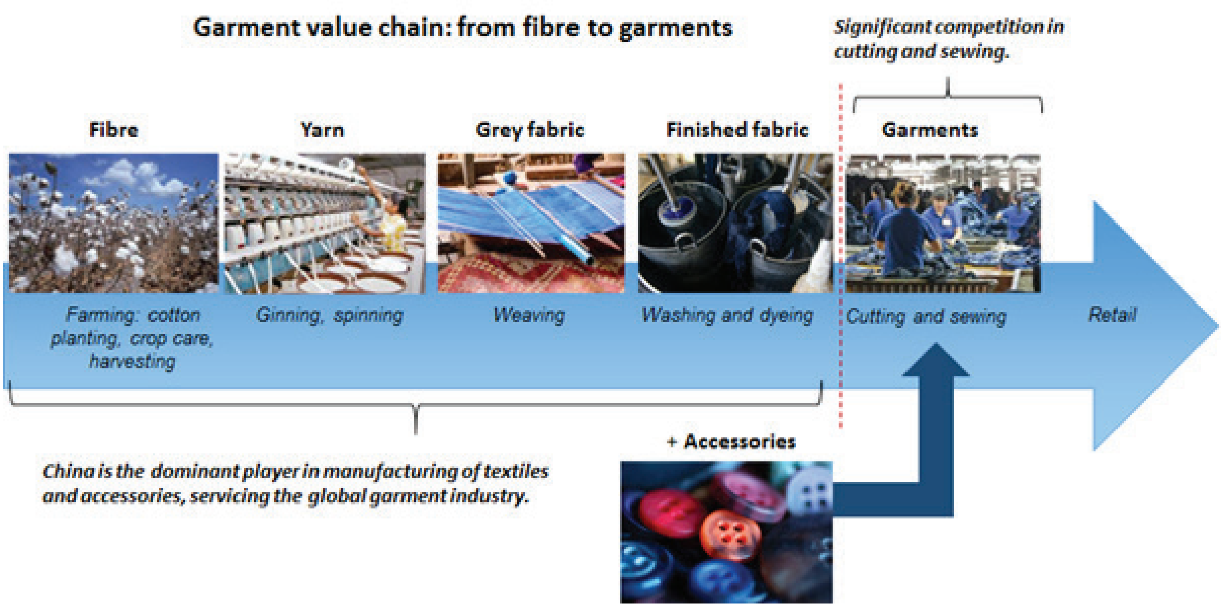
Our view on management quality can have direct practical consequences in stock valuation too. We typically do not use DCF valuations, but use earnings multiples instead, such as price-to-earnings. For instance, in the retail sector there are two companies with similar product exposure and we believe one of them should be trading at a discount due to its significant corporate governance issues, therefore we can apply a lower earnings multiple when we value that company.

Earnings sustainability

As discussed above, ESG analysis can help assess the sustainability of a business model. If it relies on misinformed customers or weak regulations for example, current earnings may not be sustainable. To that end, the payday lending industry is an interesting example.

A few years ago, the Australian payday lending industry was experiencing high growth rates but anecdotally, the industry had an issue with rogue operators, including misconduct and non-compliance issues. Consumer advocacy groups also highlighted how some operators were preying on those who could least afford it and people who did not understand the high-interest rate products they were getting themselves into. Eventually, the regulators would have to step in and investigate. One of the triggers for the investigation might have been media scrutiny, via the ABC's Four Corners show, which exposed some of the issues in the industry. Next, one of the big banks, which was a major funder of listed payday lending companies, stopped their funding. As a result of the above, some listed companies almost halved in value.

Another example is the fast fashion industry, which we believe is facing some major sustainability challenges going forward. China has for a long time dominated the supply chain in garment manufacturing. While the final stage of the supply chain (cutting and sewing) has become more competitive and China has lost market share to India, Vietnam, Cambodia, Bangladesh and other countries with low labour costs, it still dominates the first stages of the supply chain, i.e. textiles manufacturing (please see below).



This means China is not just producing textiles for its own garment manufacturing, but much of the fabric that is turned into garments in, say, Bangladesh, which is imported from China. However, while China has experienced high economic growth, it is concerned about the quality of that growth and it does not want to be stuck in low-value textile manufacturing in the future. In addition, textiles manufacturing is a dirty and thirsty industry, contributing significantly to China's environmental issues (particularly water pollution). Large areas of China are under water stress and the textiles industry competes for fresh water resources with energy and food production. China has implemented new environmental laws, which could lead to cost inflation, that would need to be passed on or absorbed along the value chain, perhaps all the way to consumers. In our view, this issue adds to a number of other structural challenges that the retail sector is already facing.

Active ownership

In addition to better informed investment decisions, the other key aspect of ESG integration to Ausbil is active ownership and engagements on ESG issues. By engaging with companies on ESG issues we may well preserve capital. In addition, engagements with companies also contribute to better informed investment decisions and can potentially expand the investible universe.

Ausbil has an extensive company visitation program and Ausbil regularly engages with companies on ESG issues, either with executive management, the board or other company representatives. In 2016 alone, Ausbil interacted on ESG issues with over 50 companies on more than 100 separate occasions. Those interactions varied from discussing a company's ESG risk management in a particular area to providing stakeholder inputs to companies' sustainability reporting and the encouragement of industry best practice in risk management of particular operating areas and stated positions on executive remuneration.

Since the introduction of the two-strike rule a few years ago, there has been greater interaction between boards and investors. Executive remuneration remains a highly important area to ensure proper use of our clients' money and also to ensure proper alignment between shareholders and management. However, Ausbil also engages frequently on other issues. Examples include climate change disclosure, food safety risk management, animal welfare standards, responsible financing and much more.

One area where Ausbil has been heavily involved in terms of engagement is supply chain management. The rationale for engaging on this topic comes down to a number of things:

- First, the way a company deals with its suppliers can be indicative of how it deals with other stakeholders, for instance consumers.

- Second, for consumer-facing companies, the brand is a key asset, but brands can be sensitive, costly and time-consuming to restore once a company has had negative publicity, which can also lead to loss of sales.

- Third, it comes back to earnings sustainability; a business model that relies on a supply chain with underpaid workers with no right to unionise may risk unrest, supply chain disruption and inevitable cost inflation.

- Fourth, there are clear productivity benefits with ethical sourcing; leaders on ethical sourcing can demonstrate that by paying a higher wage to factory workers in the supply chain, product quality improved, lead times were shorter and costs of goods sold was lower.

Ausbil has engaged with many companies on supply chain management, both labour rights and environmental risk management, through a variety of channels, e.g. one-on-one meetings, conferences, forums and workshops. Ausbil has also gone on research field trips, e.g. to the garment sector in Guangzhou, China. Typically, investors do not get to see the worst factories on such field trips; instead they see the best factories, but that can also provide significant insights as investors can learn about industry best practice and apply that to engagements with Australian companies.

Photo from ESG field trip: garment factory in Guangzhou, China 2016

Many issues in the supply chain are of a systemic nature, e.g. lack of freedom of association and the lack of so-called living wages (a wage that covers the basic costs of living), which can be significantly different to a country's minimum wage, meaning change will not happen overnight. However, we have seen some major improvements in companies we have engaged with in recent years. From our perspective, there are win-win scenarios to pursue and we do not see a trade-off between improved labour standards and financial returns; rather we believe companies with proactive management of labour rights issues will be at a relatively lower risk of supply chain disruption and earnings risk.

In addition to company-specific engagement, Ausbil has also engaged at the policy level, for example through a submission to the Australian Government on a potential Modern Slavery Act in Australia and Ausbil has hosted a number of multi-stakeholder events focused on labour rights in the supply chain.

Summary

- Responsible investments have evolved from ethical investments based on negative screening to ESG integration, where investors capitalise on ESG research to achieve higher returns. Ausbil integrates ESG research across all its funds.

- ESG is not just about environmental issues or about the long term, it can be used in the short term too and our experience is that it helps us to make better informed investment decisions.

- Companies are predominantly made up of intangible factors and investors need to analyse companies in different ways to capture all risks and opportunities.

- ESG is not just about finding direct earnings risk, it can also be used indirectly as a proxy for management quality and to assess earnings sustainability risk.

- The second element of ESG is active ownership, which can help investors to de-risk portfolios and build relationships with companies, while ultimately making better informed investment decisions.

For more information on Ausbil's ESG integration, please contact

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