American Century Investments®

Integrating ESG Factors into the Investment Process Moves the Needle Forward

July 2019

Notes from the ESG Desk

Guillaume Mascotto

Vice President

Head of ESG and Investment Stewardship

"Integration of ESG disclosures and company fundamentals is an essential component in the evaluation of an issuer's ability to mitigate a given ESG risk or capitalize upon an opportunity."

Environmental, social and governance (ESG) investing is an evolving concept that currently lacks standardized definitions, consistency and a solid baseline for analysis and measurement. Despite recent progress at the regulatory level and higher levels of issuer ESG disclosure, investors are increasingly relying on ESG information about companies, which can differ per third-party ratings, scores and other beta-type filters. Much of that data hasn't been audited or contextualized around financial materiality and company fundamentals. In fact, overreliance on that type of guidance may limit investors' ability to understand which ESG factors and their time horizons are financially material for companies.

Filling in the Information Gaps

ESG risks and opportunities are typically identified at the sector level (we call this "top-down ESG exposure bias"). To assess downside or upside risk management at the issuer level, third-party ESG ratings tend to rely on issuer-level disclosures (e.g., policies or programs and environmental ratios, such as carbon emissions/sales) that aren't always integrated with company fundamentals.

Integration of ESG disclosures and company fundamentals is an essential component in the evaluation of an issuer's ability to mitigate a given ESG risk or capitalize upon an opportunity. Not surprisingly, large and well-established issuers with the ability to dedicate greater resources to preparing extra-financial disclosures tend to achieve higher ratings than smaller issuers or those with complex business models that don't easily fit in a top-down ESG evaluation framework

While investors would undoubtedly benefit from additional disclosure about companies' ESG-related risks and opportunities, it's essential to distinguish between the quantity and quality of disclosure. We believe active ESG integration can fill in the gaps.

Accomplishing More with Integration

Beyond reliance on disclosures and ratings, we believe focusing on bottom-up risk management analysis in tandem with integrated financial and ESG variables constitutes a more substantive understanding of an issuer's financial risk exposure to given ESG issues.

For example, if an investor determined that an energy issuer's high carbon emissions were a material risk, then the investor should review the issuer's carbon intensity profile through public disclosures per third-party frameworks such as MSCI or SASB. Equally important, investors should also consider the potential impact on earnings visibility through supply/demand assessments and on balance sheets. This could be accomplished through stress testing issuers' ability to service debt amid the potentially rising costs associated with the decarbonization shift affecting the energy and electric power sectors.

Identifying Downside and Upside Potential

Even though ESG issues are often characterized as risk inputs, they may also offer opportunities. It's possible that exposure to a risk or opportunity arising from an ESG issue may not materialize for five, 10 or even 15 years. Given those time horizons, it's important to target the capability of the company to manage ESG-related potential cost hikes or liabilities, as well as the appropriate strategic direction for adapting to evolving market dynamics within a defined investment time period. Generating risk-based and forward-looking ESG assessments may help evaluate an issuer's downside ESG risk propensity and capture ESG upside potential.

For example, instead of focusing solely on an issuer's level of ESG disclosure or negative externalities (e.g., carbon emissions or product recalls), analysts should dive deeper into the issuer's ability to manage any potential current or future costs associated with exposure to ESG issues. This analysis could involve evaluating whether a given ESG issue would alter an issuer's solvency and growth trajectory over the medium to long term. If the ESG exposure resulted in an immediate to short-term cost to the company's market valuation, analysts could then assess management's remedial actions and whether any decrements to the company's fundamental business profile would be warranted.

Similarly, a dynamic integrated ESG approach could allow analysts to measure an issuer's risk mitigation programs and whether an issuer's practices were improving or worsening over time. For instance, new regulations or technological innovations could affect supply and demand fundamentals, thereby exposing companies to potential risks. But those trends could also influence companies to innovate or repurpose assets toward business lines with lower regulatory compliance risks and stronger competitive advantages.

Generating Robust ESG Assessments

Two highly ESG-exposed sectors offer insightful case studies of ESG integration:

Energy

The decarbonization of global energy use patterns presents risks and opportunities for upstream energy companies.

Investors can gauge a company's potential to capture opportunities either in the form of compliance/operational risk reduction or growth inflection in new business lines by analyzing several important characteristics:

- Reserve mix diversification toward natural gas away from oil
- Carbon emissions intensity profile and projected reduction outlook
- Stranded asset coverage
- Renewable energy investments

In this sense, while ESG integration may help evaluate potential risks at the macro (climate change) and sector (regulation, market conditions, negative externalities) levels, it should also identify those companies likely to succeed in the future. Such businesses would likely exhibit solid margins of safety, quality characteristics and possess documented strategies for adapting to the global BTU transition and International Energy Agency's 2°C Scenario.

Pharmaceuticals

Key areas for pharma companies include their approach to supply chain custody issues, international quality standards certifications and regulatory compliance.

A significant product recall can become an expensive ordeal between lost sales, replacement costs, government fines, and litigation expenses. If a company has recorded major product recalls and/or received regulatory warnings, investors should assess whether such actions could result in material costs. If so, they should also determine if the company can absorb litigation costs, withstand brand reputation damage and deploy the proper remediation steps to replace and fix defective products.

In short, if a company endured a significant public flogging as a result of gaps in product quality and safety controls, an integrated process would allow for a deeper assessment into whether the company is taking proper steps to prevent another damaging event. If this assessment revealed positive results, ACI's ESG desk would then look for risk management upside potential in the form of spread-tightening or growth inflection, based on this new course of behavior.

A strategy or emphasis on environmental, social and governance factors (ESG) may limit the investment opportunities available to a portfolio. Therefore, the portfolio may underperform or perform differently than other portfolios that do not have an ESG investment focus. A portfolio's ESG investment focus may also result in the portfolio investing in securities or industry sectors that perform differently or maintain a different risk profile than the market generally or compared to underlying holdings that are not screened for ESG standards.

Past performance is no guarantee of future results.

The opinions expressed are those of the portfolio team and are no guarantee of the future performance of any American Century Investments portfolio. This information is for an educational purpose only and is not intended to serve as investment advice. References to specific securities are for illustrative purposes only, and are not intended as recommendations to purchase or sell securities. Opinions and estimates offered constitute our judgment and, along with other portfolio data, are subject to change without notice.

This information is not intended as a personalized recommendation or fiduciary advice and should not be relied upon for investment, accounting, legal or tax advice.

No offer of any security is made hereby. This material is provided for informational purposes only and does not constitute a recommendation of any investment strategy or product described herein. This material is directed to professional/institutional clients only and should not be relied upon by retail investors or the public. The content of this document has not been reviewed by any regulatory authority.

This promotion has been approved with limitations, in accordance with Section 21 of the Financial Services and Markets Act, by American Century Investment Management (UK) Limited, which is authorised and regulated by the Financial Conduct Authority. This promotion is directed at persons having professional experience of participating in unregulated schemes and units to which the communication relates are available only to such persons. Persons who do not have professional experience in participation in unregulated schemes should not rely on it.

American Century Investment Management (UK) Limited is registered in England and Wales. Registered number: 06520426. Registered office: 12 Henrietta Street, 4th Floor, London, WC2E 8LH.

American Century Investment Management (Asia Pacific) Limited currently holds Type 1 and Type 4 registrations from the Securities and Futures Commission (SFC). American Century Investment Management, Inc. is not registered with the SFC.

American Century Investments ®

4500 Main Street
Kansas City, MO 64111
1-866-628-8826

330 Madison Avenue
New York, NY 10017
1-866-628-8826

1665 Charleston Road
Mountain View, CA 94043
1-866-628-8826

2121 Rosecrans Avenue
El Segundo, CA 90245
1-866-628-8826

3 Garden Road, Central
Hong Kong
+852 3405 2600

12 Henrietta Street
London, WC2E 8LH
+44 20 7024 7080

167 Macquarie Street
Sydney, NSW 2000
+61 2 8667 3025

