THE VALUE OF ESG
Building on a Strong Foundation

Focusing on quality has historically led us to companies with strong financial and ESG characteristics.

KEY TAKEAWAYS

• We believe ESG integration is the optimal approach to sustainable investing for value investors. It can offer increased portfolio diversification and maximizes the integration of both ESG-quality and alpha-related inputs.

• With a historical focus on quality and downside risk protection, the Global Value Equity team has systematically incorporated extra-financial issues into its investment process. Our strengthened process has evolved to include third-party ESG data and proprietary ESG research.

• Our team’s ESG views are risk based and forward looking. They are formed within the context of fundamental analysis to help determine if ESG issues present potential risks to a company’s valuation or quality profile.
OUR ESG APPROACH: TOWARD CORE INTEGRATION

We believe an investment-led and materiality-focused environmental, social and governance (ESG) integration process is optimal for investors seeking exposure to a value investment strategy. First, we think ESG integration offers greater portfolio diversification by increasing the investment opportunity set. Second, it offers more flexibility to maximize the integration of both ESG-quality and alpha-related inputs. American Century Investments® has dubbed this core integration.

To achieve core integration, our ESG integration framework aligns the firm’s fundamental research process with its fiduciary duty. We strive to mitigate related downside risks while capturing upside potential without compromising our duty to act in the best interest of clients.

ESG factors are systematically integrated into the franchise sustainability component of our investment quality framework. Numerous characteristics may help determine how a company might navigate a market cycle. They include:

- Competitive advantages (high barriers to entry, lower-cost structure, technologies) and market power (scale, vertical integration)
- Strong risk management practices (regulatory compliance, operational excellence)
- Governance standards (shareholder interest alignment, integrity and transparency)

STRENGTHENING OUR ESG INTEGRATION PROCESS

In 2016, we began augmenting fundamental analysis with a dedicated ESG assessment using third-party ESG research.

Our analysts ensure ESG risks that third-party providers identify aren’t financially material to our investment thesis. Additional enhancements that include the firm’s addition of an ESG and Investment Stewardship Team and creation of our ESG integration framework and proprietary ESG scoring system have helped Global Value Equity analysts and portfolio managers integrate material ESG and sustainability issues into our process.

As outlined in Figure 2, American Century Investments’ three-layer ESG integration framework:
- Identifies macro-level ESG issues impacting market dynamics
- Determines which of these issues are relevant at the sector level
- Evaluates ESG materiality at the issuer level

ESG analysis isn’t a substitute for fundamental analysis. We believe our approach maintains the independence of our ESG analysts and integrity of the investment process. As a result, our ESG views reflect an analysis of financial materiality and its investment implications. The approach augments an existing rigorous research process designed to help our portfolio managers make better long-term investment decisions for clients.

OUR HISTORICAL FOCUS ON QUALITY LEADS US TO COMPANIES WITH STRONG ESG CHARACTERISTICS

We first launched value portfolios in 1993, and quality has always been a focus of our investment process. As shown in Figure 1, we seek to invest in superior businesses that possess quality assets, low leverage or debt, strong risk management practices and executive teams demonstrating disciplined use of capital.

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<tr>
<th>CHARACTERISTICS</th>
<th>QUALITY ASSETS</th>
<th>LOW FINANCIAL LEVERAGE</th>
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<td>METRICS</td>
<td>High, stable and sustainable returns on capital</td>
<td>Low balance sheet risk</td>
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<td></td>
<td>Attractive free cash flow generation</td>
<td>Low levels of absolute and relative leverage</td>
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<td>Level of EBITDAR/tangible assets</td>
<td>Absolute debt/EBITDAR</td>
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<td></td>
<td>Normalized EBITDAR/tangible assets</td>
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As active managers, we generate our own investment views. However, our investment teams consider third-party ESG ratings and seek to understand the drivers underpinning these opinions. This consideration is similar to how we look at credit rating agencies and sell-side research.

Our analysts use a proprietary scoring system to assess whether ESG issues could result in risks to a security’s valuation or trigger a down-grade of its fundamental profile. The system generates ESG scores based on quantitative and qualitative environmental and social indicators that are sector-specific and derived from reported data.

Governance risk analysis is central to our fundamental research process. Our scoring system complements this analysis by benchmarking companies against governance indicators based on company-reported and third-party data, regardless of sector.

Our security scoring system also has a financial materiality function to ensure ESG risks are incorporated into our valuation multiples, discount rates and portfolio weights. We assign a final score composed of a quality rating and trend signal that is both historical and forward looking.

SELECT ESG CASE STUDIES
We evaluate the ESG attributes of each company stock before deciding whether to add it to our portfolios and monitor existing holdings for deviations in their ESG profiles.

Wells Fargo & Co.
Wells Fargo & Co. is a diversified, community-based financial services company. It is engaged in banking, insurance, investments, mortgage, and consumer and commercial finance.

- Governance controversies continue to weigh on the bank’s reputation. Because the Basel Committee has designated the company a “systemically important bank,” we believe its exposure to potential regulatory scrutiny will persist. We recognize these issues but view Wells Fargo as trending in the right direction from an ESG perspective.

- We believe the clawbacks imposed in 2017 are positive for shareholders and in line with the company’s continuous corporate governance improvement. Wells Fargo’s board is over 90% independent (including audit and compensation committees), and the company has split the roles of CEO and
chair, naming a fully independent chair. Over the last two years, the company strengthened risk management by hiring a new chief risk officer, chief operational risk officer and chief compliance officer in addition to more than 2,000 external risk management team members. It also created a Conduct Management Office to centralize the handling of internal investigations. A new Culture Program and related initiatives encourage employees to speak up about potential malpractice.

- We estimate the explicit costs linked to the cross-selling scandal and other governance misconduct to be more than $5 billion. That figure represents approximately 25% of the bank’s net income in recent years. While no doubt material, we believe these costs are manageable given the strength of the bank’s balance sheet and its profitability, which continues to be strong. The bank earned approximately $20 billion of net income annually on average over the past five years. We believe that provides a comfortable buffer to absorb these costs.

- Wells Fargo hasn’t experienced any material losses related to cyberattacks. Since 2012, the company has provided more than $70 billion in financing for renewable energy, clean technology and other sustainable businesses. The bank has also pledged $200 billion in financing for renewable energy by 2030.

For these reasons, we believe Wells Fargo deserves a much higher ESG rating and have rated it accordingly using our internal scoring system.

3M
3M is an industrial company that manufactures industrial, safety and consumer products. The company operates its business through these segments: Safety & Industrial, Transportation & Industrial, Nutrition & Health Care & Consumer.

- 3M is considered one of the most innovative companies in its space with products that can help customers achieve their environmental goals. 3M makes products that are very useful and profitable. Despite having made important environmental policy strides, we believe some of the company’s issues are potentially damaging.

- 3M has considerable PFAS chemical liabilities given that it historically manufactured both PFOA and PFOS, the disposal of which caused water contamination. Because of this significant PFAS exposure, our analysis has led to assumptions about related liability costs. Recognizing the multiple variables in the litigation process that could result in a range of outcomes, we currently have a liability of approximately $6 billion (for cleanup, personal injury lawsuits, etc.) incorporated into our valuation.

- 3M has liability exposure due to earplugs whose design allegedly didn’t maintain a tight seal and allowed dangerously loud sounds to slip through without the wearer knowing. The failure could apparently result in hearing loss, tinnitus and loss of balance. As of year-end 2019, more than 2,500 personal injury lawsuits were pending against 3M related to these earplugs. Many of the lawsuits point to internal documents, alleging the company knew the earplugs could slip and might not have been long enough to fully protect wearers from loud noises.

DuPont de Nemours, Inc.
DuPont de Nemours, Inc. is a multi-industry specialty solutions company with large global businesses. These segments include Electronics & Imaging, Transportation & Industrial, Nutrition & Biosciences, and Safety & Construction.

- Many investors believe DuPont has a potentially large liability exposure due to its production of toxic fluorinated PFOA, a type of PFAS compound. PFAS chemicals are used in the manufacture of non-stick pans, water-resistant clothing, food packaging and firefighting foam. Known as “forever chemicals,” they don’t break down in the environment and collect in human bodies. Studies link PFAS exposure with cancer, thyroid problems and developmental issues in children.

- We believe PFOA should have a lesser liability than other types of PFAS chemicals (i.e., PFOS). Many investors assign a much higher liability to DuPont because they generally don’t differentiate between PFOA and PFOS. Depending on the severity of a liability claim, DuPont shares liability costs with its spinoffs, Corteva and Chemours, which helps protect DuPont.

- Based on DuPont’s PFOA exposure, our analysis has led to assumptions about liability costs and distribution of those costs among its various spinoff companies. We believe the potential liability is smaller than what headlines seem to indicate and have adjusted our valuation models to reflect these potential liability costs.
• The combination of these factors led us to risk-adjust our overall trend assessment to negative from stable. That assessment intends to account for future liabilities, given the PFAS controversy and the company’s inclusion on the U.N. Global Compact Watch List.

ESG CHAMPIONS HELP DRIVE CONSISTENCY OF ESG INTEGRATION

The firm has designated ESG Investment Champions to help drive consistency of ESG integration across investment disciplines. Our ESG team trains each ESG champion. Within Global Value Equity, our ESG champions evaluate individual companies and run scorecards that conform with our proprietary ESG scoring system. They also work with Global Value Equity portfolio managers and analysts responsible for evaluating individual companies’ ESG risks and opportunities.

ESG AND INVESTMENT STEWARDSHIP TEAM OFFERS ADDITIONAL RESOURCES

Our discipline also draws on the resources and expertise of our ESG and Investment Stewardship Team of five analysts dedicated to ESG research. Our investment and ESG analysts work closely to ensure any risks identified by our ESG integration process aren’t financially material to our investment thesis. They can address with company management any ESG issues and controversies deemed material to an issuer’s long-term financial condition.

The ESG and Investment Stewardship Team also works with Global Value Equity analysts to monitor portfolio holdings for potentially material ESG risks and controversies on an ongoing basis. Changes in third-party ESG ratings and down-grades are reviewed monthly, and the team shares new information with the Global Value Equity fundamental teams.

ESG INTEGRATION PROCESS EXTENDS TO OUR PROXY VOTING PRACTICES

Our ESG integration process extends to our proxy voting practices. We created an ESG Proxy Team of senior legal and compliance professionals and our head of ESG and Investment Stewardship. The ESG Proxy team analyzes on a case-by-case basis the financial materiality and potential risks or economic impact of the ESG issues underpinning proxy proposals. The team then makes voting recommendations to all portfolio managers across investment disciplines. The team generally recommends support for well-targeted ESG proposals if it finds a rational linkage between a proposal, its economic impact and potential to maximize long-term shareholder value. That includes board structure, environmental stewardship, and anti-corruption and ethics controls, among other things.

ADDITIONAL ESG ACTIVE INVESTMENT SOLUTIONS

We emphasize the ESG integration approach and believe it leads to better diversification and maximizes the integration of both ESG-quality and alpha-related inputs. Our ESG program is client-centric and solutions driven.

Subject to client requests, ESG solutions for Global Value Equity portfolios range from negative screening to best-in-class tilting, to thematic investing, to impact investing.
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