Sustainable Investing

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Engagement vs. Exclusion in Public Markets

Authors

Barnaby Weiner
Head of Stewardship
and Sustainability

Vishal Hindocha
Managing Director
Sustainability Strategy

Sustainability in focus

The focus on sustainability across both the investment industry and around the corporate world has intensified significantly in recent years. One thing that may be driving this is the recognition that investment horizons have become too short. We can measure this empirically: In the 1960s, the average holding period for stocks listed on the NYSE was seven years; it is now around six months.[1] We can also observe it anecdotally: Again and again we see an obsession with quarterly results. However, what happens in, say, the next six months has almost no bearing on sustainability, which concerns itself with long-term investing.

There is also growing concern that short-term-oriented corporate behavior, driven perhaps by short-term-focused investors, is creating — or at least exacerbating — social or environmental stresses that threaten to undermine the very system in which they operate. This is not a purely altruistic concern. It is also a matter of self-interest. If we don't pay attention to the health of the ecosystem, our place in it becomes more vulnerable. We become like birds feathering our nests while ignoring the forest fire that threatens to engulf us.

So how best, in our capacity as an investor in public markets, can we play our part in creating a more sustainable future?

Is exclusion the answer?

The implied answer to that question, based on an observation of the explosion in Environmental, Social and Governance (ESG) themed funds in the past few years, is that you build a portfolio comprising only "good" companies with strong ESG profiles, and exclude everything else. This isn't de facto a bad strategy. It seems logical to us that companies addressing real social and environmental needs should, all else being equal, have better long-term prospects than companies causing harm to either people or planet. But all else does need to be equal. If a company is "doing good" but is unable to deliver sustained profit growth while doing so because it has no enduring competitive advantage, then it is unlikely to prove a good investment. And even if it does have a lasting competitive advantage, if your entry point is at a stratospheric valuation, the returns are likely to be disappointing.

There are many companies, industries and indeed whole sectors in the investable universe that are increasingly considered unworthy by typical ESG focused investors. These include companies operating in "sin" industries, poor performers on ESG metrics and companies with businesses in other controversial industries. Sin stock industries usually include alcohol, tobacco, gambling, sex-related industries and weapons manufacturers. There is a school of thought that suggests we should simply blacklist these companies, but this brings the question of impact or societal value creation. Is there any value created by excluding a company from a portfolio? Would doing that have the real-world impact that ESG-minded investors are hoping for? We think this unlikely, especially in public markets, where selling a security necessarily means there is another buyer in the open market. We teach our children that ignoring a problem does not make it go away and problems don't usually solve themselves. In the public market, exclusions or divestments make it someone else's problem — an abdication of responsibility, not the exercise of it.

Exclusion and the cost of capital

Proponents of exclusions suggest that excluding companies increases their cost of capital. At face value, this is a seductive argument. It makes sense that capital markets would punish unsustainable companies through a pricing mechanism, and indeed some companies were in the past brought to justice (or just to their senses) by investors, but is this argument compelling today? In the large, liquid public markets in which most of the investable universe operates, we think not, for three simple reasons:

1. The "pacification" of capital is likely to undermine the ability of the capital market at large to exert a coherent level of pressure.
2. Capital is presently cheap and easy to obtain for companies, so the impact of restricting investment capital in one domain should be minimal.
3. Rather remarkably, there is no evidence we are aware of supporting the thesis that excluding companies affects their cost of capital or incentivizes the type of management behavior that the exclusionary investor is seeking.

Engagement: a force for change

What can sustainability-minded investors do? Simply this — engage as proactive stewards of capital. Use the power of the capital markets as an Archimedean lever — to create the point of leverage on which we can move the world.

We need to know our limits: We should not delude ourselves that we understand our companies better than the people managing them. However, we should make it clear where our priorities lie. We expect companies to be managed for long-term value creation, not short-term profit maximization. We expect them to pay due care and attention to social and environmental externalities that could incur a material financial cost at some point down the line. And if constructive engagement bears no fruit, we will exercise our voting powers to force the issue. Engagement and proxy voting are meant to work in tandem. Proxy votes, unlike engagement alone, can provide a measurable snapshot of investor sentiment — and force the adoption of binding resolutions on companies not cooperating with investors.

While many activist investors are aggressive in their engagement strategies, the rise of collective engagement organizations has been driven by some of the largest asset managers and asset owners. Participating in collective engagement gives both larger and smaller shareholders a powerful voice for communicating and influencing change. We believe working together allows for a more efficient engagement process and encourages productive discourse on the issues at hand. Overall, collective engagement can lead to more effective, reasonable engagements that have the power to drive change in the real economy.

What about debt?

When people think about active ownership, they often think about equities. But what about fixed income, especially for investors in long maturity bonds? In our view, while there is a healthy tension between bondholders and shareholders on some issues, such as capital allocation, both want borrowers to effectively manage long-term ESG issues that could negatively impact future cash flows, as well as their ability to service debt and pay back capital. To help ensure the long-term performance of the bond and the company, we believe fixed income owners must adopt an ownership mentality like that of equity owners in order to foster an effective dialogue and influence the company. Negative screening eliminates that opportunity.

Conclusion

Most investors share a common goal: to generate strong, durable risk-adjusted returns. It is our obligation and fiduciary duty as investment managers to behave as long-term owners when we invest our clients' assets. To us, exclusionary policies limit our effectiveness and don't help us achieve this goal for our clients. We believe thoughtful engagement and proxy voting practices are vital to encouraging sustainable value creation and economic growth.

Please keep in mind that a sustainable investing approach does not guarantee positive results and all investments, including those that integrate ESG considerations into the investment process, carry a certain amount of risk including the possible loss of the principal amount invested.

Endnotes

[1] Reuters, https://www.reuters.com/article/us-health-coronavirus-short-termism-anal/buy-sell-repeat-no-room-for-hold-in-whipsawing-markets-idUSKBN24Z0XZ.

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