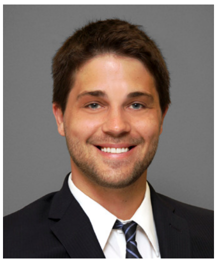
Q&A: Why We Believe Active Management Is Essential to Sustainable Investing

Vishal Hindocha
Director – Investment Solutions Group



Dan Popielarski
Associate Analyst –
Investment Solutions Group

Around the globe, investors are increasingly interested in sustainability issues. Vishal Hindocha and Dan Popielarski explain the role of active management when investing in, and engaging with, companies. Plus they look ahead to how sustainability may develop over the next decade.

What role does active management play in sustainable investing?

Dan Popielarski: Robust research has always been essential to active managers. Today, however, they have to look beyond a company's balance sheet and consider nonfinancial drivers of its business success to truly understand whether it is worth investing in long term.

Knowing a company's business is essential to understanding its sustainability over the long term. Active managers are able to look into companies and industry operations, as well as management. They can use all the available information, including nonfinancial information, to determine what they believe could potentially have a material impact on those companies. If you don't know the business well enough, you can't tell the difference between a company that is sustainable and one that isn't.

Vishal Hindocha: Sustainable investing isn't something new, nor is it treated as a distinct practice at MFS®. Rather, it is embedded in every part of our investment process. Our approach as an active manager has been one of integration, with a focus on financial materiality. We are convinced that sustainable investing through environmental, social and governance (ESG) integration, proxy voting and engagement improves our ability to identify those investment opportunities that we believe offer sustainable, long-term competitive advantages.

If we look at the bigger picture and the transition toward a more sustainable society, active managers can be a part of the transition mechanism between capital markets and the real economy by helping to deploy capital with sustainability in mind. Thinking about the value chain of consumers, companies, asset owners, governments, etc., we believe active managers have an important role to play as stewards of capital. And they are an important catalyst for the adoption of sustainability in a number of areas, including education, disclosure, stewardship and collaboration.

What are the differences, if any, between the active and passive manager approaches to engagement?

VH: Stewardship has recently become a hot topic and rightfully so, demonstrating that the benefits of thoughtful engagement and proxy voting are more important than ever.

I believe that some of the easy wins in sustainability have already happened. Given the trend toward more sophisticated and divergent sustainability goals and objectives, an active approach might be the right one for analyzing and understanding the materiality of issues, such as the knock-on effect on supply chains, for example.

Both passive and active managers have an important role to play in realizing the potential value that thoughtful engagement and proxy voting can add. While large passive managers have the size to influence voting on broad issues, their scale can hinder their ability to achieve nuanced engagements with companies.

Conversely, active management can be more fragmented. Active investors with deep research capabilities are able to perform "materiality discovery," similar to price discovery, and proactively engage with investee companies to instigate change.

DP: We believe that sustainable investing through ESG integration, proxy voting and engagement improves our ability to achieve our clients' objectives and meet our fiduciary responsibility. We are in no way convinced that offering our clients products with ESG screens or overlays can do the same. Asset owners are making an active choice by going passive and adopting the index provider's beliefs.

Active managers generally have higher coverage ratios of analysts per company, allowing our analysts to truly understand the businesses. Plus, while passive managers do get a seat at the table, their inability to divest leaves them with less bargaining power. Passive managers have tended to be less active in collective engagements; only recently have they stepped up their game.

In our experience, investors are looking for a longer-term, sustained improvement in material ESG areas that are relevant to a given company. So while we understand why transparency and measurement are important, we caution against an overreliance on narrow or blunt measurement tools, which can't be expected to capture the nuance and range of the ESG risks and opportunities faced by companies.

Can you provide an example of company engagement, and what was the outcome?

VH: To discuss our upcoming proxy vote at a US health care provider's 2019 annual general meeting, several members of our investment and proxy voting teams met with the chair of the compensation committee, along with representatives from the issuer's legal and investor relations teams. We had voted against members of the board in the past due to compensation and governance oversight concerns. While we continued to advocate for certain improvements of the governance structure, we were encouraged by changes to the composition of the board that were reflective of past engagement discussions. We note that the company continues to evolve executive compensation design to better align with its strategy. The company is also simplifying its long-term incentive plan and increasing the amount of performance-based pay. Ultimately, we voted 'for' on executive compensation as an acknowledgement of progress, but we will carefully continue to monitor compensation design, as well as oversight practices.

If a portfolio company rates highly on valuation and outlook but poorly on E, S or G, how does that impact the investment decision?

DP: On a day-to-day basis, members of our investment team consider factors that they believe could potentially affect investment outcomes. Their activities include analyzing both financial and nonfinancial information to identify anything that could materially impact the long-term value of a company. With an eye toward creating long-term value, we focus our research and investment process on understanding valuations.

When an ESG-related risk is highly material to a particular investment thesis, we weigh it heavily in our decision-making process. Any risk or opportunity that isn't expected to have a significant impact will still be reviewed periodically to ensure that it hasn't grown in importance.

VH: In assessing a case where the valuation is attractive but a sustainability factor isn't, the investment team seeks to understand if the poor ESG factor showing is material to the business; engage with the company prior to investing to understand the reasons for the ESG deficiency; assess whether the company is making improvements; and decide if the valuation/financials compensate for the ESG risk.

What should asset owners be asking their investment managers?

VH: Client alignment is at the heart of this, so it is about understanding whether your manager is aligned with your views and how sustainability is factored into the manager's investment process. Key questions to ask include the following:

- How do you approach sustainability? Is it part of your investment process, or is it a separate product?
- How do you determine whether an issue is material or not?
- Do you exclude any companies or industries based on sustainability concerns?
- Which members of your investment team have responsibility for looking at ESG factors?
- Do you engage with companies to understand how they view ESG risks and opportunities?
- Do you vote proxies in-house or outsource proxy voting responsibility?

DP: There are also questions asset owners should ask themselves: How often do you reassess your managers' approach to ESG? Are you keeping up with screens and the methodology behind them? Are you overweight technology like so many ESG funds tend to be?

How do you see sustainability evolving over the next decade?

VH: The next ten years will be crucial to achieving the challenging goals set out in the Paris accord, so it is going to be a fascinating time for sustainability. The effects of climate change are becoming more financially apparent, so the idea of planetary boundaries will become a regular part of conversations and investment theses.

We believe active ownership will become a necessity and the norm for all managers, both active and passive. There is a chance that passive owners, not only passive managers, will be punished if they don't use their voting power to build more sustainable practices at companies. Firms involved in greenwashing will be exposed as data gets better and a standard set of metrics is developed.

In the effort to achieve a more sustainable planet, investors will play a key role, and so will active managers.

If you are interested in learning more about how Sustainable Investing works at MFS, please visit us at mfs.com/sustainability.