Not all approaches to ESG are created equal—why a focus on integration, forward-looking dynamics and active engagement is the key to unlocking long-term returns in equity investments.

Investors are becoming increasingly aware of the positive changes they can effect on significant global concerns ranging from climate change to human rights. Indeed, in recent years, the question of considering environmental, social and corporate governance (ESG) factors as part of fundamental equity investment analysis has progressed from whether to how. As a growing number of market participants—from consultants and financial advisers to asset managers—incorporate ESG into their decision-making process, asset owners are presented with a wide range of potential options for fulfilling their ESG requirements.

Crucially, not all approaches to ESG are comparable, as they seek to deliver different outcomes. For example, while some asset owners may be willing to accept lower financial returns in order to achieve specific societal or environmental goals, others may only consider ESG from a risk-management lens. For asset managers, it is therefore imperative to understand the outcomes their clients are seeking.

In this paper, we describe the philosophies at the heart of Barings’ approach—and why we believe they are the most effective at delivering the desired outcomes for our clients. We also demonstrate how they are implemented across our global equity platform.
Why Focus on ESG?

Before going into the specifics, it is worth noting why we focus on ESG to begin with. At Barings, we believe ESG analysis is critical for two overarching reasons.

The first reason is economic return. Simply speaking, we believe taking ESG factors into consideration gives a holistic view of an investment. It allows our investment professionals to better assess both the potential risks facing the company and the opportunities presented to it, particularly those that may not be apparent or included in traditional fundamental analysis. Having a more complete picture is also crucial for improving our confidence in the investment thesis of a company. In particular, it strengthens our belief that our 5-year earnings forecasts will be delivered by the company. Furthermore, it helps our analysts to determine which of those factors may impact the value of the company over the time horizon.

Second, and equally as essential, we aim to identify sustainable business practices and unlock opportunities for our clients while propagating better ESG practices and improved disclosure across the industries and businesses in which we invest. We strive to use our influence to create equitable outcomes and drive positive change, which is consistent with our commitment as signatories to the UN’s Principles for Responsible Investment and UN Global Compact.

Stemming from these core philosophies, our approach to ESG is anchored by three principles:

1. **Integration**—ESG analysis is a core part of our fundamental research and a responsibility of the equity analyst (as opposed to a separate team)
2. **A dynamic, forward-looking approach**—the “direction of travel” for a company in terms of ESG can be as important (if not more important) than the current state
3. **Active engagement over exclusion**—we believe in driving outcomes through direct engagement with corporate management teams, rather than relying on exclusion lists

These fundamental principles play a central role in our investment analysis as we seek to deliver superior risk-adjusted returns to our clients.

1. **INTEGRATE ESG FACTORS INTO FUNDAMENTAL ANALYSIS**

ESG considerations can be challenging to assess quantitatively—as the scope, quality and timeliness of external ESG data varies across the equity landscape. Company data for smaller businesses and emerging markets, for instance, tends to be less comprehensive. Further, due to different methodologies, data providers arrive at different conclusions when evaluating the ESG credentials of the same company. For these reasons, while we believe third party research is a useful input to challenge our own views on a company’s ESG credentials, we do not think it should be solely relied upon to make investment decisions.

While there are different schools of thought when it comes to incorporating ESG factors into equity analysis, we have found that integrating ESG into our fundamental, bottom-up investment process is imperative to delivering better risk-adjusted returns. In our view, there are tangible benefits to having equity analysts assess ESG factors alongside the analysis of fundamental factors. In many cases, equity analysts already have extensive knowledge of the company they are researching—including years or even decades of direct interaction with corporate management teams. As a result, they are well-positioned not only to incorporate the risks and opportunities stemming from ESG into their assessment of a company, but also to recognize any improvement or deterioration in a company’s ESG practices.
Being early to identify such trends—which may not be fully recognized or valued by the market—can result in a distinct advantage from an investment perspective. Experienced equity analysts may also be better able to engage with corporate management on material issues—leading to the potential for better risk-adjusted returns.

At Barings, we use a proprietary assessment framework to capture the ESG performance of companies, which is fully integrated into our fundamental research and structured in a way that is consistent with how we assess a company’s quality attributes. The standardized qualitative assessment of a company is carried out in the three broad categories described below. Within these categories, our ESG framework groups industry research and material sustainability issues into nine sub-categories (FIGURE 1).

**FIGURE 1: Barings’ Proprietary ESG Framework**

<table>
<thead>
<tr>
<th>Category</th>
<th>Nine Sub Categories</th>
<th>Data/Issues to Consider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sustainability of the Business Model (Franchise)</td>
<td>Employee Satisfaction</td>
<td>Staff Turnover, Strikes, Fair Wages, Injuries, Fatalities, Unionized Workforce, Training and Education</td>
</tr>
<tr>
<td></td>
<td>Resource Intensity</td>
<td>Water Usage, Greenhouse Gas (GHG) Emissions, Energy</td>
</tr>
<tr>
<td></td>
<td>Traceability/Security in Supply Chain</td>
<td>Traceability of Key Inputs, Investments in Protecting the Business from External Threats, e.g. Cyber Security, Backward Integration (Protection of Key Inputs)</td>
</tr>
<tr>
<td>Corporate Governance Credibility (Management)</td>
<td>Effectiveness of Supervisory/Management Board</td>
<td>Separation of Chair and CEO, Size of Board, Independence of Board, Frequency of Meetings, Attendance Record, Voting Structure, Female Participation on Boards</td>
</tr>
<tr>
<td></td>
<td>Credibility of Auditing Arrangements</td>
<td>Credible Auditor, Independent Audit Committee, Qualification to Accounts</td>
</tr>
<tr>
<td>Hidden Risks on the Balance Sheet (Balance Sheet)</td>
<td>Environmental Footprint</td>
<td>GHG Emissions, Carbon Intensity, History of Environmental Fines/Sanctions, Reduction Programs in Place for Water/Waste/Resource Intensity</td>
</tr>
<tr>
<td></td>
<td>Societal Impact of Products/Services</td>
<td>Health/Wellness Implications of Consumption of Goods/Services, Product Safety Issues, Community Engagement</td>
</tr>
<tr>
<td></td>
<td>Business Ethics</td>
<td>Anti-Competitive, Bribery/Corruption, Whistle-Blower Policy, Litigation Risk, Freedom of Speech, Gender and Diversity Considerations</td>
</tr>
</tbody>
</table>
In the last 12 months, we decided not to invest in a glass packaging company. In our opinion, the company was facing the possibility of not being able to meet the carbon dioxide emission obligations that regulators in the European Union had mandated. During our assessment of the company, we noted that this increased the company’s risk of facing significant fines and/or higher carbon emission taxes in the future.

Such risks typically do not appear on a company’s balance sheet, and therefore may not have been evident or quantified through traditional fundamental financial analysis. However, using our ESG framework, we were able to incorporate the company’s quality metrics into our proprietary cost of equity model. The outcome was a 1% increase in the required cost of equity for the company, which resulted in what we assessed to be an unattractive valuation.

A European specialty chemicals company, which produces animal feed and human nutrition goods, has a number of innovative products and projects. Its animal feed products are intended to improve feed conversion, enable more sustainable meat production, and promote healthier animals. The company is also developing several pioneering animal feed solutions, such as products that help reduce the output of methane from cows, and produce fish feed from algae—as opposed to using scarce resources such as pelagic fish.

Using our framework, and looking at the sustainability of the company’s business model, we determined that the company was benefiting from the global shift toward more sustainable business practices. Specifically, we believed its competitive advantage was growing, and as a result, we decided to invest in what we viewed as an attractive longer-term opportunity.
2. DYNAMIC AND GEARED TOWARD POSITIVE CHANGE

When assessing a company, our experience tells us that its share performance is affected by an improvement or deterioration in their returns. This implies that the direction of travel is extremely important, and may have a more pronounced impact on the performance and outlook of a company than its current state. For instance, if it has traditionally achieved poor margins, but a new management team seems to be making positive changes to control costs or improve its product line, the starting point may be less relevant than where the company is going—particularly if the management team is reliable and capable.

The direction of travel is just as important when it comes to analyzing ESG factors, as the ESG outlook of a company can have a significant impact on the company’s investment case. For example, if a company has a strategy to reduce its carbon footprint or to improve its disclosure on environmental and social issues—and has a credible management team in place—there could be a positive and meaningful impact on its valuation. On the other hand, deteriorating ESG standards and practices may very likely have a negative impact on a company’s future outcomes.

In essence, ESG factors present both risks, which a company may need to mitigate, as well as opportunities, which a company may be able to capture by adapting its business practices. Therefore, we think it is crucial to carry out a forward-looking assessment of the company’s ESG practices, rather than simply making a static judgment based on its performance to date. This is consistent with our intention to reward progress and improvement, which we believe can uncover potential (and at times unrecognized) investment opportunities—and, ultimately, attractive risk-adjusted returns.

We engaged with a personal hygiene company to request their remuneration targets and hurdles—as traditionally, the company did not disclose this. We were successful in our engagement as the company agreed to publish a remuneration report with clearly defined targets. While we acknowledge there is still room to do more, we view the direction of travel as encouraging.

In cases like this, our analysts are able to quickly and efficiently incorporate new information into their analysis, allowing them to better understand the quantitative impact that such a change may have on the company’s valuation. A static rating from an external provider tends to be inherently backward looking and would not necessarily capture this dynamic change—at least in real time.
3. ACTIVE ENGAGEMENT VERSUS EXCLUSION

There is no one-size-fits-all approach to identifying industries or companies with good ESG standards. While some asset managers prefer to exclude entire sectors or industries, we believe a more effective approach is to actively engage with companies. That said, we will not directly invest in companies that violate international conventions on cluster munitions, antipersonnel mines and chemical and biological weapons. We will not knowingly hold securities that are materially involved in the production, stockpiling and use of these weapons at the time of investment. In our experience, excluding entire sectors is overly simplistic, has unintended consequences and can result in missed opportunities to invest in companies that are exhibiting positive change. For example, some asset managers may choose to exclude mining and energy stocks completely, despite the fact that many companies in these sectors are making incredibly transformative changes when it comes to ESG. Further, the technology that we require to fight climate change and lead us toward a “net zero” emissions future will not be possible to develop without copper, aluminum, nickel and other minerals that the mining industry produces.

Active engagement, on the other hand, can help bring about positive change and potentially result in better investment outcomes. For instance, by actively engaging with companies to improve their practices—encouraging miners to hold themselves to higher safety standards, or requesting an emerging markets company to improve their disclosures—asset managers can potentially help improve a company’s deserved valuation over time. Our investment professionals regularly meet with a company’s senior management—our equity team has around 4,000 company meetings a year—to engage on issues including ESG. This approach could unlock opportunities and boost potential risk-adjusted returns.

To us, active engagement includes maintaining an open dialogue with companies on how they can improve their ESG practices over time—from enhancing supply chain management to improving diversity and inclusion practices at the workplace. In addition, when we identify a material ESG issue, we launch a formal engagement plan with company management in order to resolve it. The plan sets out clearly defined objectives including what needs to change, by what date and how to measure success. We frequently engage with management to ensure progress is being made toward the engagement objectives that we set. If the engagement proves to be successful, we will choose to invest or retain our investment in the company.

In some cases, when a company has failed to improve over a designated period of time, or if there is a clear lack of commitment from management on resolving the issue, our quality score of the company deteriorates—and as a result, we may divest or not invest in the company.
We were monitoring a U.K.-listed diversified mining company and grew increasingly concerned about the management of its operational base. In particular, the reporting of accounts at an African-based subsidiary was irregular, and there were ongoing investigations into payments made in relation to the company’s African operations.

We actively engaged with company management over a one-year period, but noted a slow deterioration of the management’s interaction with shareholders. The transition path of the existing CEO was also unclear, although it became increasingly likely that the current mandate would be extended—which we believed would have a negative impact on the company longer-term. As a result, we chose not to invest.

**Case Studies**

**ACTIVE ENGAGEMENT IN ACTION: UNSUCCESSFUL ENGAGEMENT, UNATTRACTIVE VALUATION**

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**ACTIVE ENGAGEMENT IN ACTION: THE CARBON FOOTPRINT**

Climate change is becoming an increasingly urgent issue, and almost every company has a carbon cost, even if it’s not obvious. While companies in the energy and industrial sectors are perhaps more scrutinized for their carbon footprint, companies in industries like tech have also been shown to have a carbon cost.

We continue to engage with companies to improve their practices, including their use of resources to minimize their carbon footprint. Wherever it is more productive to conduct such engagements collaboratively, we do so. Through the Climate Action 100+ (CA100+) initiative, we are leading a group of investors to engage with a Brazilian diversified miner over its climate change policies and practices. We believe that engaging with the company as a group increases our ability to help the company not only understand our view of its climate mitigation efforts, but also showcase the improvements and progress they are making in this area. We find that through an active dialogue with the company, we can help them to shape their communication and policies and we can also improve our own understanding of their approach to this increasingly important area of focus for investors.

As a group, we are also involved in engagements with a number of resource companies through the CA100+ initiative. Keeping in mind that many of these businesses are necessary for the growth and development of our economy—even in sectors that add to carbon emissions, some companies are essential to developing clean energy—we are monitoring the environmental impact of our portfolios and have developed a model that determines the carbon footprint of each of our equity portfolios. This enables us and our clients to quantify what each dollar investment means in terms of GHG costs and savings relative to a passive investment.
ESG analysis is playing an increasingly integral role in understanding the potential risks and opportunities that a company faces. Ultimately, it can allow asset managers to form a more holistic view of a company’s prospects and the valuation it deserves. This role will likely continue to expand in years to come, with ESG becoming ever more ingrained in the way the investment industry analyzes and selects investments—as companies that have better or improving ESG practices are ultimately likely to command a higher premium in the market.

That said, approaches to ESG analysis in equities are constantly evolving and vary widely, and different philosophies result in different outcomes for investors. At Barings, we strongly believe in integrating ESG factors into fundamental, bottom-up investment analysis, taking a dynamic and forward-looking approach to analyzing a company’s ESG factors, and actively engaging with management teams to improve ESG practices.

In allowing us to quantify ESG risks and giving us a more comprehensive view of a company’s future, this approach puts us in a position to deliver potentially superior risk-adjusted returns over time—as we also seek to create a better overall outcome for people and the planet.
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