AORIS INVESTMENT MANAGEMENT

What does ESG mean to us?

There is growing interest in environmental, social and governance (ESG) considerations in investing. Many people feel a justifiable abhorrence at a lot of corporate behaviour and at the same time an appreciation that companies are part of the solution to many of the world's current and emerging challenges.

Investors today are taking an increasing interest in the behaviour of the companies in which they are invested and they want to feel that they own shares in the right sort of companies. However, like so many such terms in finance, ESG it is an abbreviation used freely and often without clear meaning.

It sounds intuitive but, scratch the surface and it's not so easy. ESG defies a simple definition. To gain any real understanding we find ourselves with lots of questions. In the context of investing:

- Does '**environmental**' mean green energy companies? Does it mean electric vehicles? Does it mean not investing in fossil fuels? What about oil derivatives, such as plastics? How should we think about the lifetime credentials of electric cars, which may draw on electricity from coal-fired power stations in running and consuming enormous amounts of scarce resources in their production.
- Does '**social**' mean diversity? Does it mean equal pay or equal opportunity and equal to whom exactly? Does it mean the exclusion of businesses such as alcohol, tobacco and gaming? What about defence? What about fast-food? What about companies who have some involvement in these areas but they are not core activities? Take for example Woolworths, which is a large retailer of alcohol (and a large retailer of fossil fuels) and is Australia's largest owner of poker machines? What about banks – post the Royal Commission should we consider them to be socially responsible?
- Does '**governance**' mean a minimum number of directors; number of independent directors; does it mean staggered terms for directors? Does it mean having an independent Chairman? How much attention should we give the executive remuneration structure, and what compensation metrics will incentivise the best governance outcomes.

In thinking about ESG are we looking for the absence of 'bad', the merely acceptable or the presence of 'good'? Do we screen in or screen out? Not everyone is going to have the same answer to these questions. What this means is that there is no uniform definition of ESG. An investor therefore needs to think about what definition makes sense to them. If you are using an external investment manager you will need to ensure that they apply broadly the same definition.

WHAT ESG MEANS AT AORIS

We believe in owning businesses that we consider to be of exceptional quality. In thinking about quality, we are looking for businesses with durable and profitable customer relationships where satisfaction rates are unusually high; the ability to grow the business by finding more customers; an enviable corporate reputation; and a high employee retention rate. As such, ESG considerations form an essential part of our investment process. **Good behaviour is, over time, good business.**

Some investment managers apply an automatic 'box-ticking' approach to selecting stocks that meet ESG guidelines. The most widely used such guidelines, the RobecoSAM Corporate Sustainability Assessment uses 600 data points per company. It has separate questionnaires for 60 different industries – the one for companies in the mining industry runs for 138 pages! Its approach includes the top 10% of companies from each of the 60 industries based on its methodology, as a result of which it includes companies from industries that we would choose to exclude outright, such as tobacco.

Rather than a quantitative, rules-based approach we take a principles-based approach to ESG. This means we believe assessing ESG requires judgement rather than mechanistic box-ticking. We take a broad, holistic view of ESG, meaning the environmental, social and governance impact of a business may show up in its customers or suppliers. For instance, Graco, which is a worldleading supplier of high-engineered liquid spraying equipment, has technology which electrostatically charges paint as it is sprayed. When used on large surfaces this significantly reduces the wastage of paint with positive environmental implications. Similarly, Croda, whose speciality chemicals are used in crop pesticides and fertilisers. One of its products helps to reduce drift when pesticides and fertilisers are sprayed from aeroplanes, again with positive environmental impact.

We are attracted to businesses that have ongoing, year-in-year-out efficiency programs. Graco's objective is to improve production efficiency by 3% each year. This means more efficient use of energy and materials, with clear positive environmental implications as well as beneficial impacts on the bottom line.

SCREEN IN OR OUT?

We both screen out as well as screen in. We won't own tobacco or gaming companies, period. We won't own banks or insurance companies, period. We won't own businesses that engage in complex tax structures and end up paying very little corporate tax. How can a company expect to draw on public resources in educating their employees, providing public health care and transporting them to work on public roads if they, as a company, don't pay their fair share? We pay a lot of attention to how openly management talk about the company's problems. In Graco's 2016 annual report, the CEO's letter included in his opening comments "we were disappointed by our top-line growth rate. We failed to deliver in 2016". Contrast this with Kobe Steel in Japan where it emerged in 2017 that the company had for many years routinely falsified quality records in steel that ended up in cars, aeroplanes and factory machinery.

WHY NOT BANKS?

In our application of ESG principles banks as an industry fall short of acceptable levels of social and governance behaviour to be considered for investing. The behavioural failings have been laid clear by the recent Royal Commission. Looking globally we don't find any country, or indeed any individual bank, that we can be confident can be considered an exception to the bad practices that have been exhibited by financial services companies globally over many years (the bad behaviour becomes apparent episodically, like through the GFC or regulatory investigation, but it doesn't mean the behaviour itself is only poor periodically). It is very hard for a bank to occupy the moral high ground for long – when your competitors are all making more money by taking shortcuts it starts to feel like 'industry practice' and if you don't follow as a bank then individuals will follow – you will lose your 'talent' to competitors. Ethical and regulatory transgressions by banks globally are simply too many to list, but the most recent one is noteworthy – Denmark's Danske Bank discovered recently that its subsidiary in Estonia was responsible for laundering €200 billion, and that half of its 15,000 customers in Estonia are suspicious! How are we as outsiders to pick the good apple from the bad if the banking regulators cannot?

A principles-based approach means we assess what the company does, not simply what it says.

HOW HIGH SHOULD THE BAR BE SET?

In making our assessment of behaviour, we don't set the criteria for 'acceptable' as perfect. An organisation employing thousands of people in many countries will likely at some point have lapses and violations. We will evaluate the scale and materiality of any violation and the way in which management responded.

We also believe that an assessment of ESG impact and sustainability must consider how sustainable the business itself is, reflecting how profitable the company is and its ability to reinvest and grow, how durable or transient that profitability is likely to be, and the strength of its balance sheet.

LOOKING LOCAL

While we don't invest in Australian companies if you apply our sensible but demanding ESG principles, the investable universe thins out rapidly. Banks and insurance companies are out. Energy companies are out, because more efficient use of fossil fuels, by the rest of the world, if not by Australia, will eventually weigh on demand. We won't own gaming companies due to social considerations.

Then the profitability of business itself has to be sustainable, which puts question marks against many of our retailers and consumer goods companies such as Coca-Cola Amatil. So, if you want to apply ESG considerations to your investing, starting with a global universe will dramatically improve your chances of finding high quality businesses that satisfy your personal criteria.

RISKS OF ESG INVESTING

Selecting investments based on their ESG credentials can introduce significant risks, if not done thoughtfully. This has been particularly the case in the area of alternative energy, where many businesses have failed as government policy has changed, competition has strengthened, or a seemingly revolutionary technology has simply not proved commercial. This includes solar panel manufacturers, ethanol fuel producers, and Australia's own Orbital Engine Company.

Good corporate behaviour is good business.

IN SUMMARY

At Aoris, we don't see a compromise between ESG principles and investment soundness. We believe good ESG is good business and in order to have a positive impact on their workers, environment and society companies must be profitable, durable and conservatively financed.

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