RBC Global Asset Management

ESG and shareholder value

The RBC European Equity team

For the last half a century there has often been a fairly narrow view of what corporate purpose and, accordingly, shareholder value has meant: maximising profits and ensuring the primacy of equity shareholders.

Much of this stems from a proposal put forward fifty years ago in the New York Times magazine by the American economist Milton Friedman. Friedman decried the proliferation of what he labelled the 'social responsibilities of business' and stated that, in his view, the sole purpose of business was to maximise profits for shareholders by driving share prices higher.

Friedman's opinion was so forthright that he claimed that any push towards business conscientiousness that took responsibility for employment, eliminating discrimination, and avoiding pollution was "pure unadulterated socialism." Fifty years later it is precisely the antithesis of this belief that is rightly being asked of companies, not only by investors, but by consumers and governments as well.

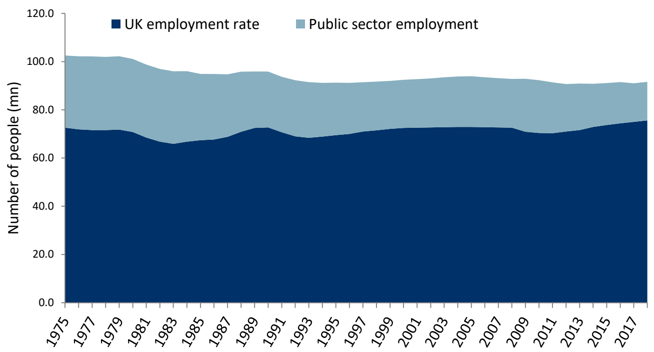
Although the term 'ESG investing' is now in common usage, its meaning and application are anything but unanimous. In our view, ESG is a direct and necessary response to the issues created over the last half a century by certain portions of the corporate world adhering to a profit maximisation philosophy at the expense of human, social and environmental capital. It is also a necessary tool to ensure long term shareholder value.

Philosophical and moral considerations aside, there are two main reasons why Friedman's doctrine seems to have failed in its application. The first is the extent to which corporations and their position within the economic and political ecosystem have changed since the 1970s.

There has been a slow but significant shift not only in influence but also responsibility of private corporations. The former stems in part from the extraordinary effect that globalisation has had on the ability of corporations to span legal, economic and even cultural jurisdictions. This has been helped in part by the dramatic shift towards intangible assets on company balance sheets over the last two decades. The shift in the twenty-first century has been particularly dramatic, with intangible assets as a percentage of ratio for S&P 500 companies rising from 30% in 1998 to 65% in 2017[1].

This increase in size and influence has been accompanied by a subtle change in responsibility between the state and corporations, partly as a result of a shift in employment levels from the public to the private sectors. In the U.K., for example, public sector employment fell from 28% to 16% between 1975 and 2018[2]. This raises the question of whether the role of the corporation has changed over this time period as more people and areas of the economy come under its sway, and whether attitudes and responsibilities on the part of corporations have to reflect this.

UK private sector employment



Source: Bank of England, RBC Global Asset Management, 2019.

The second reason for the failure of Friedman's thesis involves the consequences associated with running a business purely to maximise shareholder profits. When the focus and perceived accountability is to a single stakeholder, then the inevitable result will be the sacrifice of other considerations and increased imbalance, whether social, economic or environmental, which will in turn lead to unwanted outcomes.

Short-termism is often one of these outcomes and has led to companies borrowing capital in various forms from the future to fuel the present. This can cover all manner of borrowing, from future profits or the firm's current assets, from the environment, and even from employees. This undoubtedly leads to the issue of sustainability, as inevitably this borrowing will at some point need to be repaid.

The borrowing of environmental capital has been a theme for companies - and consumers - for most of the twentieth century and it is apparent now that we have reached the point when all participants are being forced to reappraise what it means to be environmentally sustainable. A company may be in a position to take a short-term stance on pollution or environmentally-demanding products, but this increasingly comes with costs, either in the guise of regulatory fines or consumer action, often in the form of boycotting. Technology has introduced some instances of parity between corporations and customers, as the latter's ability to influence, cajole and expose the deficiencies of corporations has become ever more prevalent through the internet and mobile technology.

Underinvestment in staff or, in some cases, their exploitation can be particularly hazardous to businesses, not just because employees become less productive over time - combined with increased turnover costs - but also as reputational damage can cost them severely in the long term.

Incongruously, even a brief inspection of the history of companies enlightens us to their original formation as multi-purpose

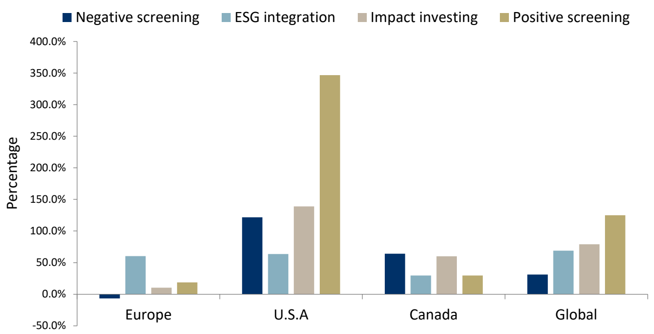
Friedman also made the assumption that the role of environmental protector would be fulfilled by governments. Although some progress has been made (such as the Paris Climate Agreement), globalisation has meant that government regulation alone is insufficient to ensure the environment is protected.

concepts, serving a number of different stakeholders, often with a social purpose. It is a fallacy to assume that companies have only ever existed on the basis of shareholder primacy. As Paul Bakus, the former President of Corporate Affairs at Nestle, has stated: 'More or less all business started out with a social purpose, so the future may look more like a rediscovery of the social purpose of business. What's been lost in recent decades is the long-term perspective.'

What does this have to do with ESG and shareholder value?

ESG investing is, in many respects, a partial redress of the issues created by companies purely focussing on the maximisation of shareholder returns. Over the last decade, ESG has become a formidable component of mainstream equity investing. Growth rates since 2016 have been particularly strong through increased public awareness (i.e. retail as well as institutional investors). Europe and Canada, relatively mature markets within the ESG space, continue to grow but it is the U.S. and other markets (both developed and emerging) where investors are witnessing particularly strong growth rates.

ESG style growth 2016-2018



Source: Global Sustrainable Investment Alliance, 2018.

Whilst the rationale behind why capital flows into these different ESG strategies may vary, the results are perhaps more focussed than one might initially assume. In general, the application of ESG criteria is to address the imbalances created by myopic corporate thinking.

In our view, the crux of the matter lies in the interplay between ESG and shareholder value. They are not, and should not be viewed as, distinct from one another. What is required is a lens through which to look at these issues over a long time horizon, as well as a holistic approach to investing that can incorporate the requisite nuance that is inherent within its aspects.

Much work has been done to attempt to structure and categorise investing within the ESG arena. Accordingly, the number of reporting instruments required of companies globally has risen from 60 in 2006 to 383 in 2016[1]. This is married to an astonishing rise in ESG indices, now approximately 10,000 in number[3]. This has led to a number of issues, not least that the exponential increase in data, much of it self-reported and incomplete, can result in information overload where much becomes contradictory or even unusable. Even the scores provided by external providers frequently have very low correlations between them, demonstrating the intrinsic subjectivity involved in the process. The bigger problem, however, is that it has allowed an industry to grow that uses this data as a means to invest without perhaps taking into account the bigger picture.

Take, for example, one of the difficulties with negative screening based on scoring: it can serve as a self-reinforcing feedback loop, whereby those companies that are - or are able to appear as - 'better' companies through ESG criteria, will benefit from increased (often passive) investment, while those that don't are left unaffected by the beneficial influence of asset owners and investors. Just as importantly, negative screening inherently focusses on perceived risks rather than potential opportunities which may well include an improvement in corporate sustainability.

As a result, increasingly there is a requirement for fundamental work to accompany any of this data, especially as certain sectors and industries require a deeper understanding to ascertain which criteria should apply, rather than the rather blunt-instrument approach of forcing companies to address the entire spectrum.

This is where we believe the benefits of active management can be realised.

But the rationale for including ESG criteria must extend beyond short-term trends and should be applied for authentic investment reasons. Accusations of 'greenwashing' are increasingly aimed at asset managers who wish to benefit from the rise in ESG investing and therefore superficially nod towards it in their investment process. This brings us back to the issue of shareholder value and compatibility with ESG. It is our belief that the focus on profit maximisation has frequently damaged long-term shareholder value by sacrificing the long term for near-term price increases. It also creates issues and imbalances across economic, social and environmental areas.

Taking into account the broad reasons set out earlier, long-term and, just as pertinently, sustainable shareholder value is increasingly dependent upon the understanding that a wider responsibility from company management is required. This is not only as a result of the external pressures from the rise in ESG investing, but also because of the evidence that there are benefits from doing so; not just the theoretical benefits as set out above, but also the tangible evidence based examples such as these:

Example A

Help a Child Reach 5 was a campaign launched by Unilever as part of its sustainable living plan, aiming to drive value for the business, employees and customers. By building into the plan relevant aspects of the UN Sustainable Development Goals, the company is also actively contributing to the wider sustainability of the environments in which it operates.

Lifebuoy soap, a product first introduced at the end of the nineteenth century, is the biggest soap brand in India. Using this product and its well established history, the goal of Unilever's campaign was to reduce the number of child deaths through diarrhoea and other preventable infections. To do this, the company began a handwashing education programme in the Bihar district in India which had a significant impact on the rates of diarrhoea in the region (down from 36% to 5%.) This campaign is part of a wider Unilever programme to change the hygiene behaviour of 1 billion consumers across Asia, Africa and Latin America by 2020, and to prevent 600,000 child deaths every year.

Whilst the social benefits to society are self-evident, the value for Unilever (and thereby its shareholders) is driven through brand growth speed, reputational benefits, and reaching hitherto inaccessible areas for its product.[4]

Example B

Novozymes is a global leader in biological solutions, creating and producing enzymes and other bioinnovations for various industries across the world, including agriculture, food and beverages and household care.

With 13% of sales invested in R&D the company is constantly looking to innovate its product range, much of this focussed on the efficacy of its enzymes. Through this focus on quality rather than quantity, the company is able to help consumers reduce their environmental footprint in a variety of ways.

Assisting consumers, and even other companies, in this way can help to create a virtuous circle for Novozymes. For example, the enhancement of crop yields through the application of particular enzymes reduces the resulting environmental damage through wider-spread agriculture, whilst the introduction of probiotics as a substitute for antibiotics in poultry rearing can assist in the stemming of antibiotic-resistant strains of bacteria. The efficacy and use of these products helps to reinforce competitive moats for Novozymes, especially as the social and regulatory climate requires industries across the board to take these issues into account.

These are just two of the many examples of the circular nature of business and society and demonstrates that sustainable shareholder returns are dependent on the social context within which companies operate. Opportunities within society create opportunities for businesses rather than the other way around.

How can this be applied through the investment process?

Information is no bad thing. It is how information is used and applied which is the key. To that end, there are two important elements to ensure the sustainability of businesses and their returns. The first is that it requires a long time horizon to implement and enact either the checks and balances or change required. This is made more complicated by the dramatic changes that have occurred over the last twenty years in the average holding period of company stock, from around eight years in the 1960s to a matter of months more recently[5].

Couple this with a tendency for investors to judge investment managers on relatively short time-frames (at least in relation to the long-term nature of shareholder value realisation) and it becomes clear why there has perhaps not been the pressure from the asset management industry required for businesses to make the necessary changes to address the issues mentioned earlier. Admittedly, part of the problem lies in the fact that shareholders cannot be homogenised in the way that Milton Friedman declared they could be, as different investors will desire different outcomes subject to their views, position and investment horizon.

The second is that the most efficient way of ensuring the sustainability of business models and management teams is through company engagement. This should not be construed as the number of votes cast for or against management at AGMs. Instead it is through management meetings and open dialogue that change can be enacted or the continuation of best practice can be ensured. Scoring and screening, though useful as data sources such as flags for potential risks, can be precarious when used in isolation. To that end they should be considered an input rather than a driver of ESG integration.

Correlated with this is the need for an active view on materiality for individual corporate circumstances. This requires a recognition that a pragmatic approach is needed when applying different ESG factors, subject to industry, geographical region as well as regulatory considerations. There are some principles that generally apply across all jurisdictions, but it is the materiality of the remaining principles that needs to be identified and analysed accordingly. Material factors are also liable to shift over time as both companies and the environment in which they operate change. All of this can produce positive outcomes for the identification of good companies in which to invest, whether through the uncovering of those quality companies that can prove their worth to shareholders over the long term, or identifying new trends that will shape the corporate landscape.

Conclusion

Even with the exponential rise in the ESG industry over the last decade, grey areas remain across the board. It is important to note that there is no simple solution to many of the issues set out above, despite an innate desire to see simplicity and more rigid categorisation. What is clear, however, is that a theoretically straightforward concept put forward half a century ago as to how companies should be run has resulted in unintended consequences, many of which are now coming to the fore.

ESG is in many ways a response to these consequences, whether they are environmental, social, or concerned with the governance of corporations. Just as importantly, shareholder value and ESG investing should not be viewed as distinct. It requires a nuanced, in-depth understanding of companies – their human elements and their balance sheets – as well as the cultural landscape in which we currently reside, rather than an unsophisticated reliance upon screens or outsourced scoring mechanisms.

The RBC European Equity team believe that long-term active management is one of the most effective ways to address these issues, but it is a route that requires patience, as well as the collaboration of consumers and regulators. It is also the way that can ensure that the values of all stakeholders are taken into account, shareholders included, whilst simultaneously promoting the sustainability of economic returns.

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Freddie is a product specialist on the European Equity Team at RBC GAM. Prior to joining the organization in 2018, Freddie was Head of Investment Oversight for the London local authorities' collective investment vehicle. In that role, he helped to oversee the pooling and management of up to £35 billion of pension fund assets, with a focus on investment analysis, manager selection and oversight. He spent the preceding few years assisting with the creation of the underlying investment management company, guiding it from concept to launch. He also previously worked for a large British multinational investment bank in London.

Sources: [1] Bank of America Merrill Lynch, 2018. [2] RBC Global Asset Management, Bank of England, 2018. [3] Bernstein, 2019. [4] Unilever, 2019. [5] Bank of England Staff Working Paper No. 571.

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