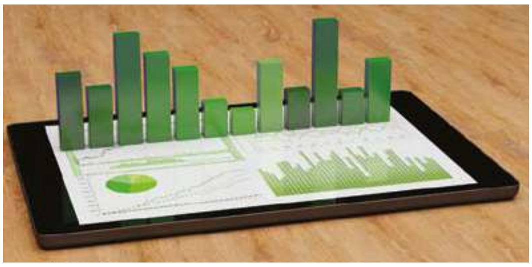
Active management: Essential to sustainable investing

Looking at the role of active management when investing in and engaging with companies, and how sustainability may develop over the next decade



What role does active management play in sustainable investing?
James Lindsay: Robust research has always been essential to active managers. Today, however, they have to look beyond a company's balance sheet and consider non-financial drivers of business success to truly understand whether it's worth investing long-term.

Knowing a company's business is essential to understanding its sustainability over the long term. In our view, active managers have a better ability to look into businesses and industry operations as well as management. They can use all available information, including non-financial information, to determine what will have a material impact on those businesses. If you do not know the business well enough, you can't tell the difference between one 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 within every part of our investment process. As an active manager, our approach has been one of integration with a focus on financial materiality. We are convinced that sustainable investing through 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 towards 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. Asset managers are an important catalyst in improving the adoption of sustainability in a number of areas, including: education, disclosure, stewardship and collaboration.

What, if any, are the differences between active and passive manager approaches to engagement?
Hindocha: Stewardship has recently become a hot topic and rightfully so, demonstrating that the benefits of thoughtful engagement and proxy voting is more important than ever.

I believe that some of the easy wins in sustainability have already happened. Given the trend we are seeing for more sophisticated and divergent sustainability goals and objectives, an active approach might be better at analysing issues, understanding their materiality and having the ability to look-through the issues, for example, at the knock-on effect on supply chains.

Both passive and active managers have an important role to play in realising 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 could hinder their ability to effect nuanced engagements with companies.

Conversely, active management is 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.

Lindsay: 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.

This is because 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 specific company. Whilst we understand why transparency and measurement is important, we caution against an over-reliance on narrow or blunt measurement tools, which cannot be expected to capture the nuance and range of ESG risks and opportunities faced by companies.

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

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

If a potential portfolio company rated highly on valuation and outlook but poorly on E, S or G, how would this impact the investment decision?

Lindsay: On a day-to-day basis, members of our investment team consider all relevant factors that could affect investment outcomes. Their activities include analysing both financial and non-financial information to identify anything that could materially impact the long-term value of specific companies. 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 will weigh it heavily in our decision-making process. Any risk or opportunity that is not expected to have a significant impact will still be reviewed periodically to ensure that the issue has not grown in importance or potential impact.

Hindocha: In assessing the case where valuation is attractive but a sustainability factor is not, the investment team would seek to: understand if the poor ESG factor is material to their business; engage with the company prior to investing to understand the reasons for 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?

Lindsay: Client alignment is at the heart of this, so it's about understanding whether your manager is aligned with your views as well as understanding how sustainability is factored in their investment process. Key questions to understand these include:

- How do you approach sustainability – is it part of your investment process or is it a separate product?
- How do you identify 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?

Hindocha: There are also questions for asset owners to 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?

Hindocha: The next ten years will be crucial to reach the challenging goals set out in the Paris accord, so it's 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 part of regular conversations and investment theses. Active ownership will become a necessity and the norm for all managers, both active and passive. There is a chance that that passive owners, not passive managers, will get punished if they do not use their voting power to build more sustainable practices at companies. Firms involved in "greenwashing" will become more obvious as data gets better and a standard set of metrics are developed.

Lindsay: If we wish to move towards a more sustainable planet, investors will play a key role and we believe that active managers are set to be a crucial part of the transmission mechanism of where we are today and where we dream to be.

If you are interested in hearing more about the role of active management in sustainable investing, please contact James Lindsay on jlindsay@mfs.com.

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