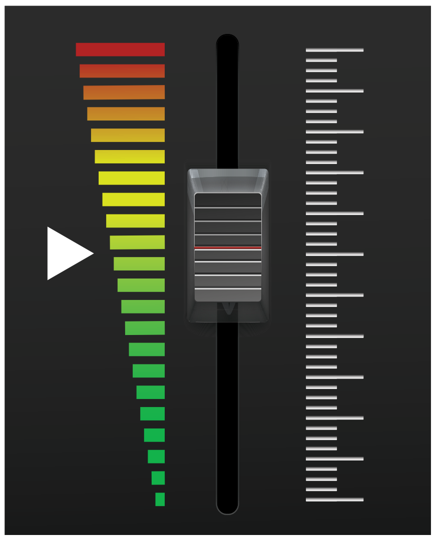
Turning up the volume on sustainable returns

Raj Shant explains how two key Newton investment strategies, dividend income and sustainable investing, can be combined to help deliver sustainable, long-term returns

Many schemes need the certainty of a regular and sustainable income as their income requirements change over time. They need to ensure that they have the 'cushion' of an assured and consistent income stream to avoid having to sell assets at the wrong time in the cycle to meet payout obligations to members. In this context, this article brings together two investment strategies that we employ at Newton to help us drive long-term returns for our clients: dividend income and sustainable investing.

Both these approaches share a number of traits, such as emphasising the sustainability of a business and its cash-generation capability. Our sustainable investment strategies allow us to take a view on both the sustainability of a company's business model and its future prospects, while our dividend-income approach has always been tilted towards seeking out companies that can demonstrate sustainability in terms of the recurring dividend stream they provide to their investors.

We take a three-dimensional view on what 'sustainability' looks like within our investment process. First, we look for companies displaying the economic durability in their business models that can support a sustainable level of income over the long term; secondly, we take account of material externalities, by which we mean the consequences of



commercial activity that affects other parties without being reflected in a company's own accounts, such as carbon emissions; and, thirdly, we harness our responsible investment analysts' research to evaluate the sustainability risks and opportunities of a company in an environmental, social and governance (ESG) context, alongside conventional financial criteria.

The benefits of compounding

One of the best known (and yet most forgotten) truths of equity investing is that the biggest determinant of returns is the dividend income and the growth of the dividend over time, creating a powerful compounding effect over the long term. Within our equity-income strategies, we implement a strict yield discipline in pursuit of a superior level of compounded income to the market. For us to buy a stock, it must offer a yield premium over the comparative index, and, if the yield on any stock that we own falls below that of the market, it must be sold.

Equities are often still primarily regarded as being in a portfolio purely to provide capital growth. However, thanks to the power of compounding, and with bottom-up fundamental analysis that seeks to unearth quality companies with strong business models at reasonable valuations, we believe that equities can also be more accurately regarded as a reliable and sustainable source of income. This is especially true if investors can look through the short-term volatility and view equities as a longer time-horizon asset in the way that alternatives such as infrastructure or private equity are regarded. While capital returns can be volatile, income returns are less so, and, as mentioned above, they are also the key determinant of an equity investor's long-term returns.

We have always viewed a healthy dividend in two ways; first, as a healthy cash reward for shareholders, and secondly, and more importantly, as a potential indicator of disciplined capital allocation. For healthy cash rewards to be sustainable and able to grow over the long term, capital allocation is crucial. For investors to exploit the power of compounding, a disciplined investment approach is equally crucial. The combination of the two can significantly improve the statistical likelihood of generating strong long-term investment returns.

Our responsible investment approach

We believe looking at ESG factors can help investors pinpoint risks beyond those identified in a company's financial statements – risks that can have a material impact on a company's performance and reputation. Analysing these non-financial issues can also provide a valuable window on a company's culture and emerging risks: in effect, how a company's managers behave when they believe no one is looking. This forms another layer of risk management alongside the more conventional financial analysis. It can also serve to highlight qualities and opportunities that could be missed in purely quantitative analysis. It is another perspective on how sustainable a company's cash generation is in the long term.

At Newton, we distil our responsible investment strategies into three broad categories. The first of these is exclusions and screening, which is an investment approach that we have run since 1988 for some of our faith-based and charity investors. The second is ESG integration, which is the way that we manage the vast majority of our clients' assets (and has developed as part of the evolution of our investment approach since our inception in 1978). In this approach, ESG analysis is a key input into the investment decision-making process. However, the ultimate decision about whether to include a security in a portfolio lies with the portfolio manager. This means that we may invest in companies that have a lower relative ESG score, if we believe that the valuation of the stock adequately compensates us for the risk posed by its weak ESG profile.

Finally, the newest element of our responsible investment approach is what we term 'sustainable' investing. In this category, we place added emphasis on positive ESG credentials, equal to the financial considerations. We omit companies with attractive financial characteristics, if those characteristics are accompanied by a poor or deteriorating ESG profile, unless we believe that through constructive engagement we can help bring about an improvement in ESG outcomes within a predefined timeframe. Our suite of sustainable investment strategies is increasingly gaining traction as investors demand greater levels of clarity and corporate accountability over ESG issues.

There is a growing belief within society that companies should be about more than simply financial profits, and that there should be evidence of a more sustainable approach to their business models. A cursory glance at the majority of regulatory and legislative changes taking place around the world can confirm the direction of travel. Around us on an almost daily basis, we observe companies affected negatively by consumer boycotts, union action, regulatory fines, huge clean-up costs, expensive lawsuits and damaging press and social media coverage.

All these actions show an increasing expectation of better execution of ESG considerations by companies. However, we believe responsible investing is about a lot more than simply aiming to avoid the potential pitfalls. To our minds, companies that are well aligned with this changing zeitgeist are likely to be in a better position to maintain and grow their dividend payouts over the long term.

Newton's 'red lines'

Our new sustainable strategies have principles-based 'red lines' that help to ensure the poorest-performing companies are not eligible for investment. We will not invest in companies that violate the UN Global Compact's 10 principles that promote responsible corporate citizenship (relating to areas such as corruption, labour standards, human rights and the environment). We also avoid companies with characteristics that make them incompatible with the aim of limiting global warming to 2 degrees celsius. Finally, we incorporate a tobacco exclusion as we do not view tobacco businesses as compatible with our commitment to sustainable investment.

In addition, the responsible investment team have a power of veto over investing in a particular security, if they believe a company or government is beyond redemption and cannot improve. We do not expect the veto to be needed, but it is a strong signal of what matters to our sustainable strategies both internally and externally.

By combining our pioneering equity-income and sustainable-investing approaches, we are merging two key strengths of Newton to create what we believe is a compelling investment proposition, which should resonate with investors. By harnessing the power of compounding and the insights of detailed ESG analysis, we believe we can produce attractive income streams in a truly sustainable fashion.

Written by Raj Shant, portfolio manager, Newton Investment Management

In association with NEWTON Investment Management

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