SCHAFER | CULLEN
CAPITAL MANAGEMENT

Transcript: Anuca Laudat – Introduction to ESG Investing with Schafer Cullen

1. What is ESG investing and why should investors pay attention?

ESG, which stands for environmental, social and governance, is an investment philosophy that evaluates a company's governing framework and its long-term impact on the environment and society. The term ESG was coined in 2005 in a study presented at the Who Cares Wins conference which showed that ESG issues can have a financially material impact on companies, which then led to a series of discussions with investment professionals around how best to integrate ESG into the investment decision-making process. Ultimately, ESG factors represent a collection of non-financial performance indicators that allow investors to assess the strength of a company's governing structure, its ability to attract and retain top talent and its commitment to responsible corporate behavior.

2. How can ESG factors help investors avoid future risk?

Some examples of ESG factors include board composition and independence, structure of incentive compensation packages, diversity and inclusion across the organization, carbon and emission reduction targets, and so on. ESG is one of the best measures we've found for signaling future risk – in fact, 15 out of 17 (90%) bankruptcies in the S&P 500 between 2005 and 2015 were of companies with poor Environmental and Social scores five years prior to the bankruptcies. Environmental, social or governance issues may seem intangible, but they can have a very real effect on long-term returns.

3. Why do investors need to look beyond third-party ESG ratings?

With increased public interest in ESG investing comes increased interest in how to assess a corporation's commitment to ESG and how to measure its impact. But even rating agencies don't often agree on what makes a good sustainable investment. Third party data alone will not provide answers for those who seek to invest in companies that reflect their own ESG priorities. A single company can receive very different ratings, so investors also need to understand what isn't captured in traditional metrics. Fundamentally, third-party ratings are backward looking, whereas we as investors are forward-looking. Our job is to understand where there might be opportunity that the market is not yet recognizing or identify a risk that is yet to be understood. We use ratings as a starting point when evaluating companies on ESG. What informs our opinions is the fundamental data points we extract from third party providers and blending that with our own views, gathered from other sources, our industry knowledge and engagement with company management. But disagreement among ESG ratings providers is not necessarily cause for dismissal. Just as value and quality measures may present different views on a company, so too ESG scores can be helpful in the right context. For example, is a high percentage of part-time labor a reflection of a company that doesn't want to pay benefits or one that has a seasonal business? Is high turnover the result of poor company culture or recent M&A activity? And how much can historical data really tell you about where a company is looking to go with its sustainability efforts? With ESG, the devil is in the details. Deep research and one-on-one interaction with company management can uncover opportunities and risks that scores don't yet reflect. Our job is to make those judgments and investment decisions based on this information.

4. What is Schafer Cullen's approach to ESG investing?

Our approach to ESG research is holistic, meaning that we approach every new investment with a balanced analysis of all environmental, social and governance factors. That being said, our focus remains on materiality, namely the ESG factors that we believe contribute to alpha generation over the long term or indicate a potential source of risk. We are careful about the exclusion filters we apply to our initial screening process, which currently includes coal mining, oil sands, firearms, controversial weapons, gambling and tobacco. ESG integration spans every aspect of our portfolio management, from the initial stages of our research process to the ongoing portfolio monitoring and ultimately our sell discipline. What we believe makes our strategy's profile compelling is that we are one of the few managers that is focused on value and ESG in equal measure. We are often asked about how our value and ESG investment styles work together. In truth, we find them to be self-reinforcing. In practice, what often happens is that the companies that pass through our high-quality filter often also meet our thresholds for high-quality ESG practices. We believe that by combining these two investment styles we offer investors a compelling long-term return profile, whereby we benefit from the long-term outperformance potential of value stocks, the risk mitigation of our ESG work and the long-term alpha generation of both styles.