Sustainable investment in Good Companies

By Gabriel Herrera, ARTICO Partners (October 2019)

ESG, sustainability, responsible investing and many other similar expressions have come to the forefront of attention of professional investors globally. Regulators are planning to add their rules to the game. Professional investors must therefore deal with the question of whether and how to engage with ESG. However, the theme has several stumbling blocks when one starts thinking about implementation in real portfolios.

When implementing ESG, we believe it is of highest importance to preserve fulfilling the primary objective of professional investors and their fiduciary responsibility towards their ultimate beneficiaries, namely to maximize the probability of long-term sustainable outperformance. There are several ways how to implement ESG.

Applying Exclusion criteria

One of these avenues ist the «exclusion philosophy», which intends to avoid providing financing capital to certain companies. Applying varying negative or positive selection criteria investors can reduce their available investment universe to different degrees by banning certain bad sectors or badly rated companies from their investment options before even starting their investment decision-making process. This can range from excluding a very small numbers of really bad companies (like land-mines producers) to – on the other extreme - allowing investments only in the very few ESG leaders (like MSCI ESG AAA rated companies). Many variants between the two extremes exist.

While the "ESG-exclusion-light" approach has only a marginal impact on the total ESG quality of a portfolio, it preserves an almost intact investment universe. The "ESG-exclusion-hard" approach significantly reduces and completely changes the investment universe to choose from. The investment performance outcome of this extreme approach is completely dominated by the individual company risk of highly rated companies and more importantly the significant sector and country/currency bias resulting from such strategy.

Generally speaking, exclusion can be a valuable strategy to follow, but in its extreme versions seems either to be meaningless or to be significantly detrimental to the investment opportunities of the professional investor and his beneficiaries. So, while some element of exclusion of the worst ESG-rated companies seems a plausible and necessary element, it cannot – on its own – be a sufficient component of a smart sustainable investment strategy.

Engaging directly with management for tangible impact

In an ideal world, this seems to be the most promising strategy: Shareholders - as ultimate owners of companies – can and should actively engage with the management of those companies to achieve meaningful progress towards a better ESG score. It really sounds like a constructive and responsible way forward. We also believe this is an absolutely necessary avenue, but it requires meaningful ownership of individual companies and a dedicated process to really influence (or change) the management. This is best done by huge investor organisations with significant share capital behind to be taken serious by the respective management teams. Their achievements will be measurable in the very long term. Some doubt may prevail as to the effectiveness of such approach. Shareholder activism exists now for decades and shareholder activism has certainly had an impact in specific circumstances, but are activists not struggling most of the time, because they find themselves in a minority situation when it comes to challenging excessive executive compensation and other important themes? We therefore in principle fully support ESG-related engagement strategies, but do not believe that it is effective enough for the majority of investors who will lack critical size to influence boards and management.

Fully Integrating ESG into the core investment process

Our research indicates that the full integration of ESG criteria into the core investment process allows to maintain or even increase the probability of superior investment performance, to achieve immediately a significant improvement in terms of total ESG quality in the portfolio and maybe most important of all, can be implemented by any investor regardless of his size and relative importance.

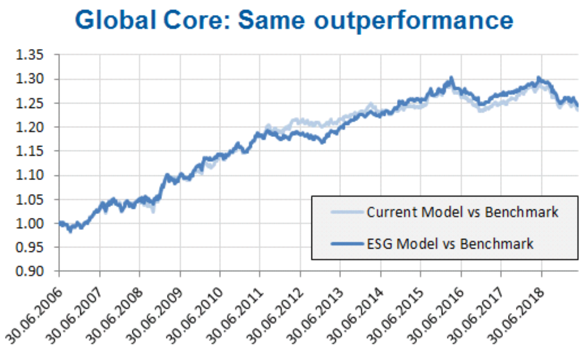
At Artico Partners, our starting point has always been, that «good companies» have a higher probability to outperform. We have defined good companies as those with high scores along the four dimensions «Growth», «Profitability», «Balance Sheet Quality» and «Valuation». Since 2011 this proven approach has produced excellent investment results based on these unique fundamental portfolio characteristics. Since summer 2017 we have adopted the guidelines of the SVVK (Schweizerischer Verein für Verantwortungsbewusste Kapitalanlagen), which was founded and is backed by the largest institutional investors in Switzerland. Their concept covers both a limited exclusion list as well as a long term engagement effort.

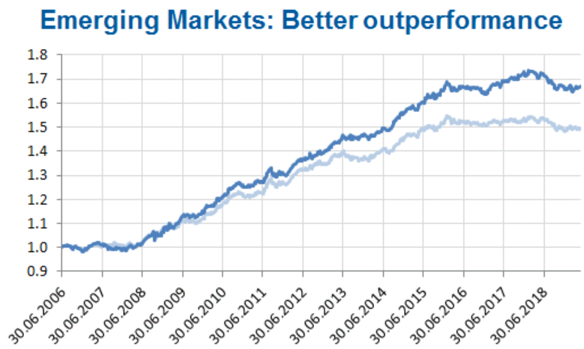
Our concept of investing in good companies is evolving now to fully incorporate ESG criteria to define what is a good company and what is not. In essence, our starting hypothesis was that in future good companies not only needed to excel in terms of Growth, Profitability, Balance Sheet Quality and Valuation, but also in terms of ESG criteria. Over the last quarters our research on a full integration of ESG criteria into our core investment process as the fifth dimension has proven successful and since October 2019 all ARTICO portfolios invest in companies with the best total scores in all five dimensions.

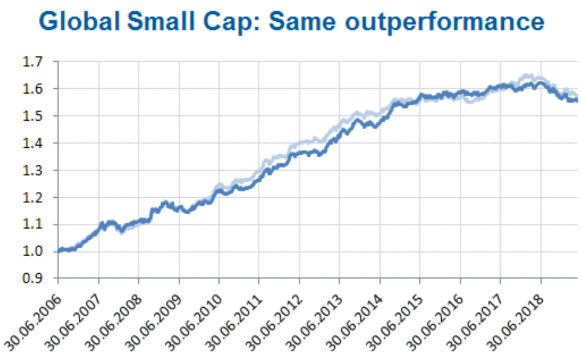
One could be tempted to consider a move into ESG and Sustainability as pure marketing-gimmick and simply as playing the current hot theme. The following charts will show that there is much more tangible benefit than simple story-telling.

Integrating ESG preserves ARTICO's past outperformance track record

Our simulations reveal that our historic outperformance would not have been diluted by integrating the ESG dimension as can be seen in the following Graph:







- Adding ESG to Historic Simulations does not dilute ARTICO's past outperformance
- Historic ESG simulations are of limited value, as ESG research coverage was very low in the past
- ESG-coverage has significantly improved lately and will be an important dimension for the future

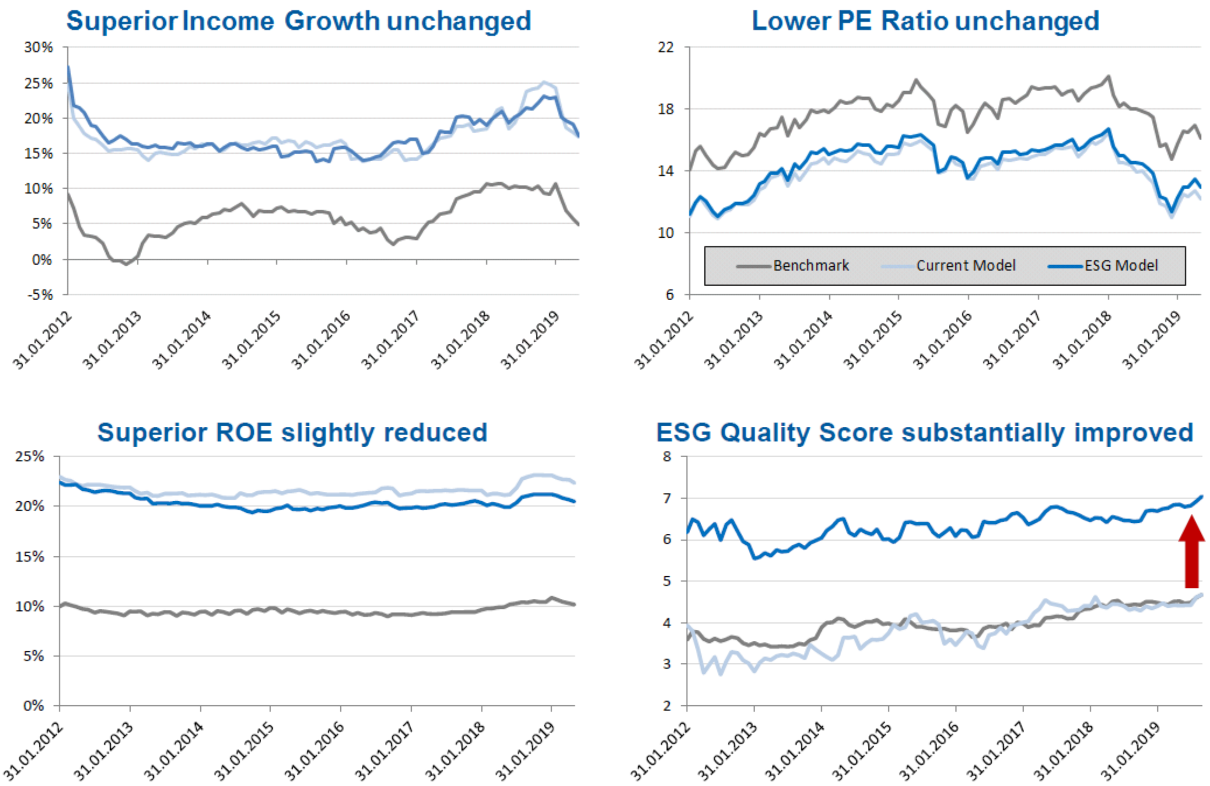
Note: Wealth Relative of Simulation with and without ESG Dimension criteria

In Global Core and Global Small Cap Equities, the outperformance of both simulations looks very similar, while in Emerging Markets it seems that adding ESG criteria slightly improves the historic outperformance.

Not only are the results not very different, but the historic testing of a full integration of ESG criteria has significant limitations, as the availability of ESG data does not have such a long history, in particular not in Emerging Markets and in smaller cap stocks. However, going forward, the availability of ESG scores will be significantly improved and ESG can therefore now be used as a meaningful selection criteria.

Unchanged fundamental portfolio characteristics with a significantly improved ESG score

As the historic simulations are not that meaningful, the focus should be on how the integration of ESG affects the fundamental characteristics of the portfolio as these characteristics were and continue to be the main source of outperformance probability in ARTICO portfolios.

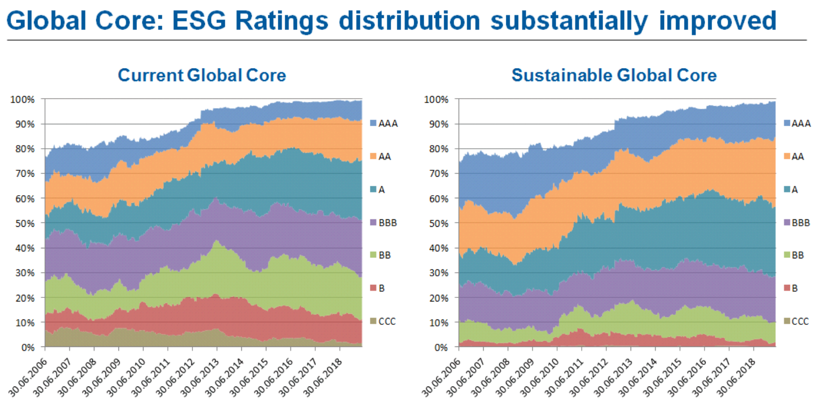


This Chart shows that by integrating ESG criteria into our core investment process, the fundamental characteristics of ARTICO portfolios remain largely unaffected: The ESG-integrated Portfolios still have a significant Growth premium, a much higher Profitability and a significantly lower Valuation than the investment universe or benchmarks.

What is really significantly different, is the ESG quality score of our Portfolio: It has significantly improved and one could call this solution to be a move towards pareto-efficiency, as all the prior good attributes are unchanged, but the ESG rating is significantly improved. We consider this the key feature as our future outperformance will continue to depend on the unique portfolio characteristics along these five dimensions.

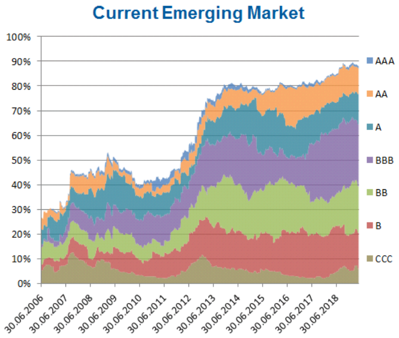
Improving the exposure to ESG Leaders and Laggards

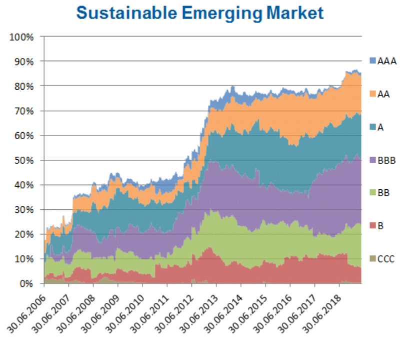
The full integration of ESG criteria into our core investment process has also a meaningful effect on the exposure towards ESG Leaders and ESG Laggards across all three Investment Universes.



- Investment in Leaders (AAA and AA) rises from 24% to 47%
- Investments in Laggards (B and CCC) falls from 11% to 1%
- Rating Coverage traditionally high, is now almost 100% of Portfolio

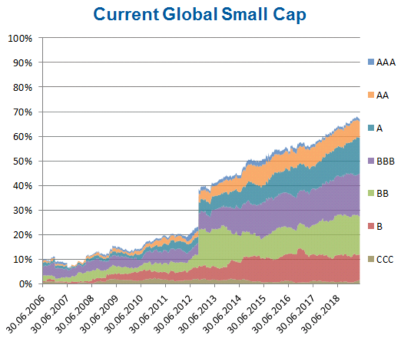
Emerging Markets: ESG Ratings distribution much improved

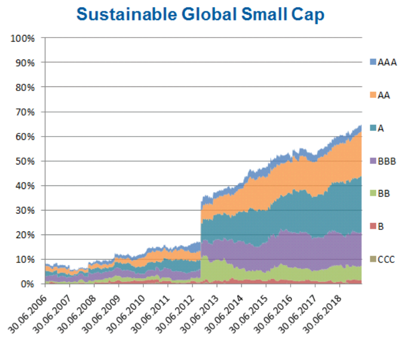




- Investment in Leaders (AAA and AA) rises from 11% to 18%
- Investments in Laggards (B and CCC) falls from 21% to 5%
- Rating Coverage historically low, is now almost at 90% of Portfolio

Global Small Cap: ESG Rating Distribution significantly improved





- Investment in Leaders (AAA and AA) rises from 8% to 21%
- Investments in Laggards (B and CCC) falls from 12% to 1%
- Rating Coverage historically very low, is now above 60% of Portfolio (and rising)

It is also very noticeable how different the historic coverage in terms of ESG rating has been in the various investment universes. We believe the ESG-coverage has now reached a high enough threshold to be used in our investment decision making and expect it to increase further in the years to come.

Summary: Investing in Sustainable Good Companies by fully integrating ESG criteria

ESG is a dominating investment theme and is here to stay. While there are benefits in exclusion lists and engagement strategies, we consider the additional full integration of ESG criteria into the core investment process as absolutely essential.

By adding ESG criteria as a fifth dimension (next to Growth, Profitability, Balance Sheet Quality and Valuation) to our definition of a Good Company we can construct portfolios with the same unique fundamental characteristics that were the basis for our past outperformance, but with significantly better ESG rating.

ARTICO Sustainable Portfolios allow professional investors to adopt a fully integrated ESG approach to their equity investments. Exclusion criteria and an active engagement approach is covered through our adoption of the SVVK guidelines and the full integration of ESG criteria into our investment process allows investing in companies with superior fundamental characteristics with an immediate impact on the total ESG quality of their investments.