Artico Principles for Responsible Investments

By Gabriel Herrera, CEO ARTICO Partners (October 2019, updated April 2021)

ESG, sustainability, responsible investing and many other similar expressions have come to the forefront of attention of professional investors globally. Regulators are adding their rules to the game. Professional investors must therefore deal with the question of whether and how to engage with ESG.

Statement of Policy – Overall Approach to Responsible Investing

Artico Partners' policy is to fully incorporate responsible investment criteria into our investment process across all our funds with the primary goal of maximizing the probability of long-term sustainable outperformance for our clients. In applying several ESG considerations we will always assess their potential positive impact on performance and risk mitigation.

Applying Exclusion criteria – Positive and negative screening

One of these avenues is the exclusion approach, which intends to avoid providing financing capital to certain companies considered bad in terms of ESG. Applying 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 number 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 company and factor risk of highly rated companies and more importantly the significant sector and country/currency bias resulting from such a 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 is a plausible and necessary element, it cannot – on its own – be a sufficient component of a smart sustainable investment strategy.

Artico Partners' approach to exclusions and screening seeks to avoid investing in companies with the worst ESG and carbon characteristics without shrinking the available investment universe in an excessive manner. Amongst our filters, we apply the exclusion list of the SVVK (Swiss Association for Responsible Investments), we exclude companies with the worst MSCI ESG ratings, companies producing controversial weapons, companies with very severe controversies against the Principles of the UN Global Compact, companies with the worst carbon footprint & intensity and companies from the Coal industry.

Stewardship: Engaging directly with management and voting policy

Engagement and voting is a very 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 quality. We believe this to be an absolutely necessary avenue. But it also requires meaningful share ownership of individual companies to really influence (or even change) the management. This is best done by large asset owners and managers or groups with significant share capital behind to be taken seriously by the respective management teams. Active engagement comes at a cost to the investor. The costs include the engagement work with company management itself (whether provided by a third party or not), proxy voting administrative costs and the potential need to block shares from trading during several weeks for voting purposes. Asset managers have the fiduciary obligation to balance these costs against the achievable positive impact. Engaging in symbolic, but impact-less activism is rather not in the interest of investors. We consider therefore divesting out of companies not fulfilling ESG criteria as a viable alternative outcome of an engagement strategy of an active asset manager.

Artico Partners fully supports meaningful ESG-related engagement strategies and follows therefore the SVVK engagement practice. Artico's engagement and proxy voting policy prioritizes on our larger share holdings. As active managers, we aim at avoiding investing in companies with significant ESG issues to start with. Candidates with significant ESG issues will mostly be divested.

Fully Integrating ESG into the core of the investment process

Our in-house research shows that the full integration of ESG criteria into the core investment decision process allows to maintain or even to increase the probability of superior investment performance. It also allows to immediately achieve a significant improvement in terms of total ESG quality in the portfolio. Most importantly it can be implemented by any investor regardless of his size and relative importance as a shareholder.

At Artico Partners, our starting point has always been that «good companies» have a higher probability to outperform. We have defined good companies historically 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, 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.

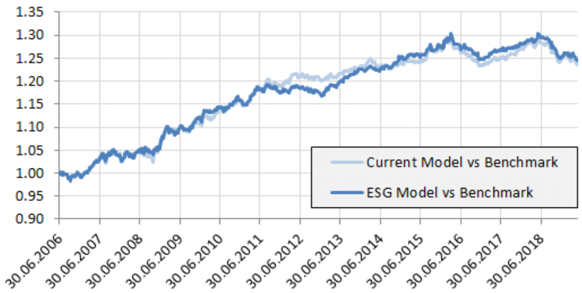
Our concept of investing in good companies has evolved in 2019 to fully incorporate ESG criteria to define a good company. In essence, our starting hypothesis was that in future good companies not only need to excel in terms of Growth, Profitability, Balance Sheet Quality and Valuation, but also in terms of ESG criteria. The fundamental reason why a high ESG score is a good predictor of future out-performance is threefold: First, a high ESG score (compared to its peer group) is a good proxy for a stronger management team. Secondly, a high ESG score is a good indication for better risk mitigation and thirdly, a high ESG score will attract more investment flows in the foreseeable future. Our research on a full integration of ESG criteria into our core investment process as the fifth dimension has proven successful and 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.

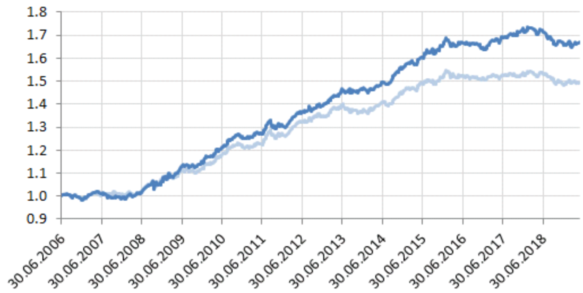
Integrating ESG preserves ARTICO's past outperformance track record

Our simulations reveal that our historic outperformance is not diluted by integrating the ESG dimension. In Global Core and Global Small Cap Equities, the outperformance of both simulations looks very similar, while in Emerging Markets adding ESG criteria slightly improves the historic outperformance.

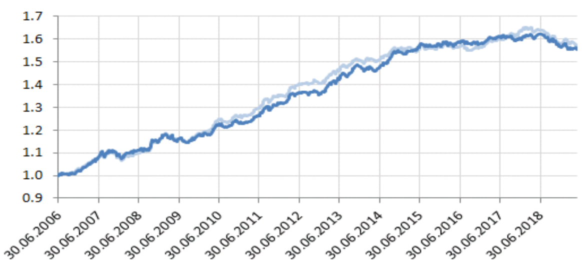
Global Core: Same outperformance



Emerging Markets: Better outperformance



Global Small Cap: Same outperformance



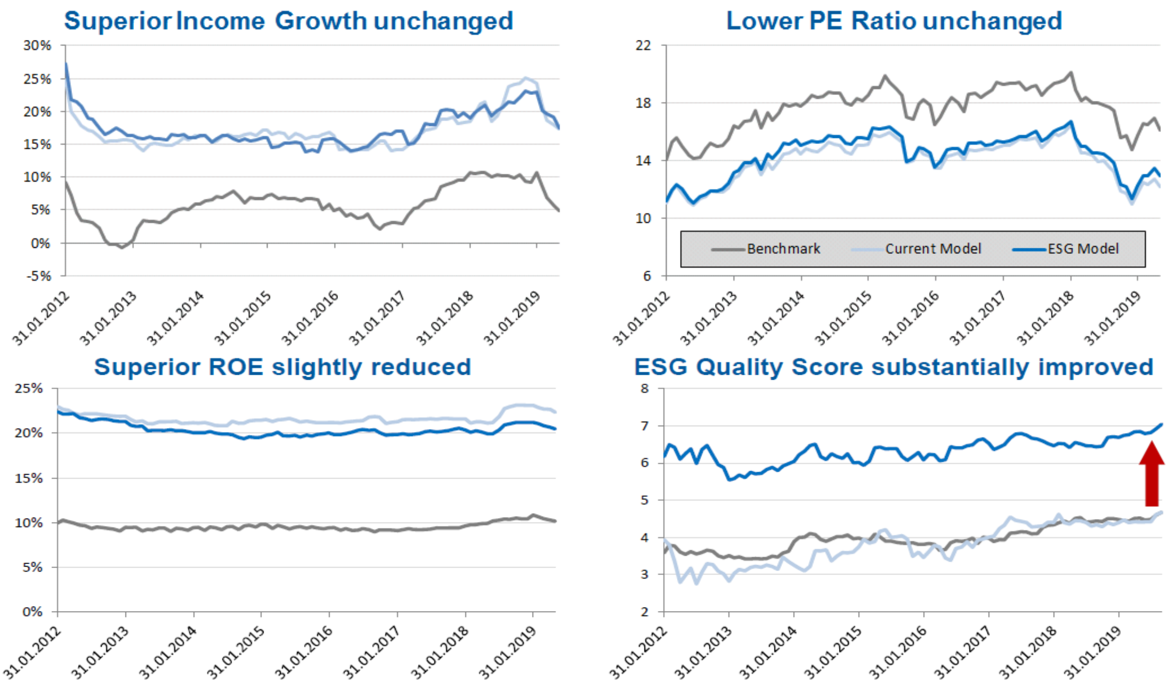
- Adding ESG to Historic Simulations does not dilute ARTICO's past outperformance
- Historic ESG simulations are of limited value, as ESG research coverage was very low in the past
- ESG-coverage has significantly improved lately and will be an important dimension for the future

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

Of course, testing a full integration of ESG criteria historically has significant limitations, as good quality ESG data do not have such a long history, in particular not in emerging markets and for smaller cap stocks. However, the availability of ESG scores has significantly improved by now.

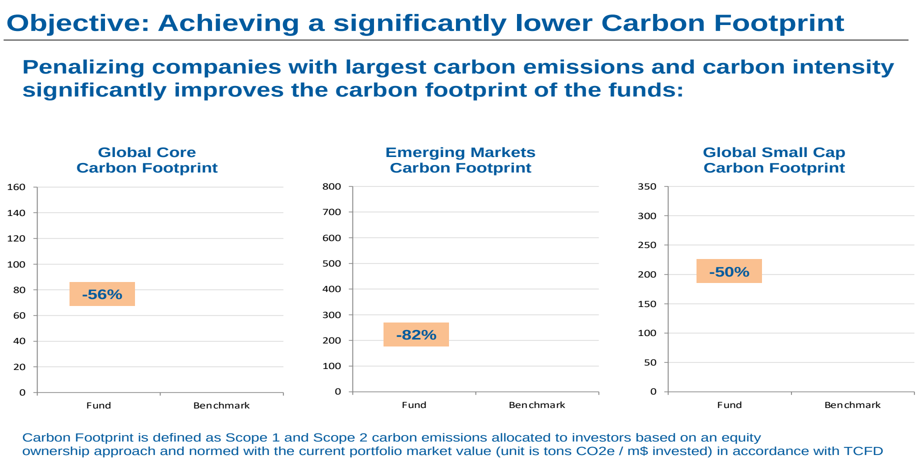
As simulations have limitations, our focus should rather be on how the integration of ESG affects the fundamental characteristics of the portfolio as these characteristics were and continue to be the main source of outperformance probability in ARTICO portfolios. In particular, we believe that investing with a sole focus on ESG could bear the danger of excessive valuations or of neglecting other fundamental attributes.

The charts below show 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 different is the ESG quality score of our Portfolio: It has significantly improved. This is very important to us: The integration of ESG was not a trade-off between Responsible Investing and Superior Fundamental Characteristics. On the contrary: By integrating ESG, our outperformance probability increased.



Climate Objective: Reducing our Portfolio's Carbon Footprint

Besides ensuring that our portfolios excel in terms of their fundamental characteristics (Growth, Profitability, Balance Sheet Quality and Valuation) and achieve very high ESG scores, one particular focus is on reducing our carbon footprint to align ourselves with the Paris agreement objectives. This does not automatically come with high ESG scores alone, but need additional considerations in terms of avoiding or at least limiting investments into carbon-intense companies. Typical investment benchmarks either focus on ESG or on Paris-alignment. At Artico Partners, we want to achieve both. The chart below shows the significant reduction of our portfolio's carbon footprint compared to market benchmarks. We intend to continue a path of further de-carbonization to align ourselves to the 1.5 degree objective of the Paris climate agreement.



Governance for Responsibility Principles and Policy

As a small boutique firm, we do not have a segregated ESG department. The entire firm, its Board of Directors, its executive committee, its investment committee, its remuneration policy and its daily portfolio management activities are deeply and directly involved in all aspects of implementing these principles for responsible investments across all of our funds.

We are signatories of the UN PRI, follow the engagement work of SVVK, implement their exclusion list, support the Paris climate agreement, support and align our portfolios to the principles of the UN Global Compact and are also a supporter of TCFD.

Principle Adverse Impact Disclosure and ESG Reporting: We report to our clients regularly our status and progress in terms of ESG quality and carbon footprint.

Summary: Investing in fundamentally Good Companies with very high ESG scores and very low carbon footprint is not only possible, but increases the outperformance probability.

ESG is a dominating investment theme and is here to stay. While there are clear 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. We have shared some of our key findings in this policy and have also published our research in Wilmott Magazine, September 2019: Gabriel Herrera and Michael Brenneis, "Sustainable Investing: Encouraging Evidence for Investors".

SUSTAINABLE INVESTING

Is sustainable investing a positive or negative contributor to outperformance? And how patient do investors need to be to capitalize on any positive effects? Our research results answer these questions, and our conclusions on the required time horizon may come as a surprise for investors hesitating to introduce sustainable investing, write Gabriel Herrera and Michael Brenneis.

Sustainable Investing: Encouraging Evidence for Investors

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