Audio Commentary Transcript: ESG Factors Are Inherent to Our Fundamental Equity Team's Process
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Patrick: Welcome to the first in a series of ESG podcast that Brandywine Global is going to produce covering a variety of topics. My name is Patrick Kaser. I'm head of the fundamental equity team here at Brandywine. With me today is Jim Clark, the director of research for the Fundamental Equity Team. And one of the reasons we're doing this as ESG is getting increasing prominence, as you know, in the investment world. It's really quite stunning at this point. Approximately half of all U.S. mutual funds say they incorporate ESG and that rises to almost 60 percent of equity funds. And so one of the questions that comes out of this that we're going address today is what does that really mean? Is it really believable that 60 percent of equity funds incorporate ESG?

One of the catalysts for this move is the adoption of the United Nations Principles of responsible investment or the PRI for short. And it was certainly a catalyst for Brandywine, which became a formal adopter a couple of years ago. And around the world, it's sort of becoming the necessary standard, if you will, for many asset managers. We do see differences around the world globally in terms of asset owners and how much they prioritize ESG. 50 percent of asset owners outside of the USA say ESG is a high priority for their investments. Only 27 percent of North America asset owners say it's a high priority.

One of the challenges, though, as we think about how managers are integrating ESG into their process is "what does integration really mean?" One of the major consultants recently did a survey of their clients and asset owners, and buyers are concerned about what they call greenwashing. And let me explain what we mean by that. A lot of times consultants take a meeting with an investment manager and they'll want to talk about ESG. And that asset manager will have a point person for ESG that handles that meeting. And it's very impressive. And they talk about everything the firm is doing both in their products and internally. And then the consultant takes that next step or the potential client takes that next step and does its due diligence with the investment team and starts asking them questions. And a lot of times the portfolio manager and the analyst can't really answer those questions. And so, you get this mix where firms are saying they integrate it, but you talk to the investment teams and it's less clear. So what we want to address today is what do we at Brandywine mean by integrating ESG into the process? What do we mean by engaging? And I think it's important to note, as I said in the lead off, you're not dealing with a brand new one ESG specialist here. You're dealing with two members of the investment team, two senior members of our fundamental equity investment team.

So let me kick it over to you, Jim. When we talk about how we integrate ESG into the process, what do we mean by that?

Jim: Well, integrated means we don't have an ESG team or there's certain things that you must do in order to have a fundamental view of a company. Its rewards and its risks. And three of those have initials of ESG. That's how we look at it. There the job of an analyst on a company. It's quarter our process. It's always been quarter our process. When we started thinking about this and when we sign the RPI, yeah, we asked, OK, what are we going to need to do different than we did in the past? And we'll talk about that in a minute. But what we realized was that our analysts were already doing these things. I remember a chemical company years ago, early in my career, where it went broke because of an environmental risk which was thoroughly disclosed in the 10K. If you were just bothering to read it and look for that kind of stuff, and if you're not looking for environmental risks on a chemical company, you know you're not doing your job as an analyst, whether you call it ESG or not. All you need to do is look at G.E. over the last few years to understand what governance can do to a situation. Look at social media today. If you're not thinking about, social risks in companies like that, you're not doing a full analysis of risk. So the way we think about risk is, how would we lose our clients' money? And that could be a balance sheet risk, which is obvious from the financials. But it could also be environmental. It could be governance. So we don't outsource balance sheet risk analysis, nor do we outsource this.

Patrick: So, Jim, I think that's a pretty key point, because we do feel that we were doing many of these things before. We do feel that analyzing the risks was part of our job. But maybe we should expand a little bit on what

exactly is different now than maybe it was two years ago, because two years ago we didn't have a list of ESG engagements and our client books, recent engagements. We weren't a PRI signatory. So maybe getting into some specifics is exactly what we've changed or modified since becoming a PRI signatory to make this more formal in the process might be helpful for the audience.

Jim: Well, by becoming a signatory, we were taking responsibility to document to clients, document to the world, that we're doing what we say we do. So that involved literally documenting these things. So when an analyst puts out an initial write up on a company or we try to do once a year in updates, they're expected to have a full ESG analysis specifically. And at first, that felt awkward with a number of companies where, what do we need and ESG what do we need an environmental analysis for on a bank? So some of them it's not as relevant, but you certainly need governance on that. But let's take an example where an environmental analysis became very relevant in a place you wouldn't have expected to see it. This wasn't a chemical company. It wasn't an oil company, actually mixed beverage cans. About nine months ago, an analyst picked up very early before the world picked it up, that in a world where plastics were considered a threat to the planet, beverage cans look pretty good because they're 100 percent recyclable. And since then, this company's customers, and more important, those beverage companies' customers have demanded a substitution from plastics to cans, which has benefited this industry tremendously. That was an environmental observation. It was a good one. Not a risk which we might not have uncovered as quickly as we did if we weren't specifically looking for these things.

Patrick: One of the reasons that we have the analysts do it ourselves and do the work ourselves, as opposed to using rating services, is at least for our fundamental equity team's process, we really think it's important, analysts know the companies well, they should be able to identify the issues that really matter for the companies that we're dealing with. There's ESG services out there that rate companies with a holistic score. One of the things that we do in our team is, as Jim mentioned, we require a formal write up when we first buy a stock, including an ESG section. So there's more rigor around that than maybe there was a couple of years ago. We also rate each area separately, the E, S, and G components, and we might break that on a future podcast. But we do a red yellow screen score and we're really looking for things that are relevant. We're not looking, for example, as I remember from earlier in my career, you know, a soda company that sells Pepsi on military bases and gets flagged by Defense Department screen. That's not really the intent of those screens. Now, Jim, maybe you want to talk about why we do it ourselves a little bit more. I will say at Brandywine, we have a variety of products. We have sovereign bond products. They may need a different process. We have quantitative products where those rating services are actually a lot more useful and fit better with the process. But from a fundamental standpoint, when we're doing individual company research in depth, Jim, maybe if you want to talk a little bit about why it's important to do it ourselves from our perspective.

Jim: So let's think a little bit about how our fundamental equity process works. Usually an analyst and a portfolio manager in collaboration with each other will work through all the elements of an investment idea presented to the rest of the team. All those elements certainly includes ESG. If those things, as Patrick said, are relevant to the valuation or risk of the company. But let's take an example and let's say we were outsourcing that and we were getting a score from elsewhere. So the analyst and portfolio manager, do their whole analysis, come to the team, present it and then someone asks "what about ESG?" Oh, let's get the score. It's a four. OK. So what do you do? How do you wait that? It's clearly exogenous this your process, you've probably already 90 percent made the decision. That reminds us of putting it is the last page of your write up as that ESG stuff rather than something that really is germane to an investment decision. And we believe it is. And the more we do it, the more we believe that.

Patrick: Jim, that's an excellent point. Talking about how it's germane to the decision, because one of the things I think about and that we've been asked by clients or clients seem to be thinking it, but maybe not saying it out loud is "why exactly are you doing this?" Why exactly we did we did side at Brandywine to become a PRI signatory? And from my perspective, there are several reasons. One, there is evidence out there, certainly on the governance side that it produces better results, better managed companies, better companies with better governance do better over the longer term. The evidence seems to be more mixed on the environmental and social side, in part because tobacco stocks have had such a great run in the U.S. the last 10 years. That skews the data. But we but we believe it is good for companies to be thinking about this stuff. We believe it's good for Brandywine to be thinking about this stuff. And we're seeing a lot of client demand. And it's interesting. And,

you know, Jim, go where you want with this. But in talking with companies the last couple of years, we've seen a definite shift in their tone as well in terms of how they are ready for and address these issues.

Jim: Why do companies adopt things? Because their customers demand it often. Sometimes companies leave their customers. Other times customers leave their companies. And this is a little bit about our clients educate us. And we like to be able to know something they don't too, about some of these things. So it's been a collaborative process in that sense. But we see that across multiple industries. I've talked before about beverage cans, where the customers who are beverage companies, Coca-Cola, Pepsi, and more especially their customers who are often millennials, who are concerned about the environment, are leading the change from plastics to truly recyclable containers. When we ask a question to CEOs and believe me, this is not a let's tag an ESG question on at the end of the meeting kind of thing just so we can check a box. And we've had meetings where half the meeting is on ESG. We met with a timber company. And sustainability is critical in an industry like that. Why? Because the customer is demanding it. You are not going to do business with Starbucks if you are not sustainable. If you are not producing the proper score by Starbucks' standards, not by yours, by your customers standards. And we're in a similar position as investment managers so we can have a conversation with a CEO. And if they're not thinking that way, they could very well be the company that's going to lose the contract from Starbucks. We do not want to be in that situation.

Patrick: And Jim, you've also talked about how in talking with company managements, there's been cases where they've talked about the market demand from their own employees. If you want to touch on that a little bit.

Jim: One of our favorite questions we've been asking certain types of managements, old school industrial companies, places where you think we're on the wrong side of specifically E matters environmental. And we've gotten some interesting answers to this question. So how do you hire millennial employees who are concerned about this? What do you tell them? And certain CEOs we've talked to, their eyes light up and they're very proud of what they tell us. And these are chemical companies. These are paper companies. And they're very proud of what they can tell a millennial employee about how they're distinguishing themselves from the industry, why their process is sustainable. And that's important. It shows, A, they're thinking about it and B they're getting results of the matter.

Patrick: So, Jim, there's two things I want to pick up on in mentioning the conversations we have with management. So first, one of the things that the PRI asks for is engaging. So we've talked a little bit and introducing the concept of integrating into the process. But you touched on it that there is many times where a third to a half of the meetings we've had with some companies are on ESG. So I think back to the time we met with Chevron's CFO in our offices, we spent probably a third of that meeting with a top level C suite executive talking about ESG issues. I visited Ingredion out near Chicago and we talked about where their next five years of goals are going to be. There's this engagement element. It's not just documenting. Okay, here's where they are and we've read the sustainability report, which we do, and we've read the proxy and we've read the risk factors. But there's also this next step of engaging. So maybe moving from integration into the process and then engagement with companies. When we see a company with an issue, maybe talk a little bit about some of the things we've done. There are some of the conversations we've had.

Jim: When we're thinking about negative issues. And as we've been talking about, they're not all negative that we identify. When you find a negative issue as an investment manager, you have two choices. You cannot buy the company, which we've exercised that choice at times, or you can buy it and think about ways to mitigate that. One way to mitigate it would be "okay, it's not a big deal to the valuation of the investment because..." Another way to mitigate it is to engage with management and attempt to change it.

Patrick: Yeah. And so, some of the things that we've done, we've had a number of companies where we've written the board, talked to the board, talked to management about their compensation metrics. In the energy industry, we had people being paid on total shareholder return and we felt that means that being less bad than everybody else on a compensation metric or stock performance still leads to richly paid executives. We've added that to more absolute metrics like free cash flow and return on capital, things of that nature. We had Norwegian cruise lines in recently spent again a third of the half to the meeting with them to talk about, "OK, IMO 2020 is coming. It's going to have major impacts to marine fuel usage. What are you doing with scrubbers? How are you

making your ships more energy efficient?" We also talked with them about their use of plastics. They're getting away from single use plastics on a lot of their ships. Things of that nature. So it does vary from company to company in terms of how we engage. But we have five years ago, three years ago, I would say, Jim, at least that we might have just kind of noted the risk and said, all right, we know it's there, but now much more active in our conversations with management.

The other thing that comes up sometimes is people look at our portfolio and they say, "all right, you have 18 percent in energy stocks. How exactly are you integrating ESG into that?" So a couple of points I want to make here. First, the PRI doesn't say we can't own anything. What we tried to do is make sure we're being appropriately compensated for the ESG risks we're taking. We're not going to sit here and pretend to you out in the audience that we're impact investors. There's a range of ESG and sometimes people look and say, all right, 60 percent of funds are ESG integrated in some way. We honestly don't believe that number from talking to some of our peers. But there is this point out there that does it prohibit you from owning anything? And look, you all are the clients, potential clients. You're going to drive some of that as well, but from our perspective we're trying to document the risks, make sure that we get compensated for them and essentially acknowledge that they're out there, that valuation isn't the only thing that matters. But at a price, these risks are reflected in that price. So I think it's important to think about. And Jim, I don't know if you have any additional thoughts. You want to kind of chime in on not owning things, owning things, how you think about price versus the ESG risks that are out there.

Jim: I mean, as a research director and an analyst for nearly 20 years, the big sin against a process is by losing money because of a risk that you should have found because it was disclosed and it was knowable. There's things that just hit you out of left field. There's a million ways to lose money in this industry. And if you can control the ones that you should be able to control, which are disclosed, which are knowable, which are analyzable, all that goes a long way to mitigating risk of bad outcomes. And this just adds another layer to that where E, S, and G things where they are germane to a company's business and valuation and governance always is, that you know we've done the work on that. It's always been a wrong answer to give to Jim, the director of research. So if you read the proxy. No, it doesn't matter. Okay, bad answer. Likewise with environmental and social risks that are obvious with some businesses. And once again, the answer can't be "the rating's four." We need to understand those as part of the business.

Patrick: So we've talked a little bit about our actually a fair amount about the risk side of things. And, with the beverage canned company, we'd certainly talked about the opportunity because aluminum is infinitely recyclable when compared to plastics. But Jim, I know that recently, just in the last week or so, you've worked on an European company that does, I believe, heat exchangers. And maybe you want to talk a little bit about the opportunity side of things, because on the one hand, there's the companies where either whether it be fossil fuels or something else, where they're being left behind. But on the flip side, there are these companies that are going to take advantage of some of the trends that we see out there.

Jim: Here's an example where an analyst picked up something because we've been looking at this at ESG specifically E in this case as to what a heat exchanger is. I don't think I would've known what a heat exchanger was if I stepped on one. But this was a major business of this European company. And what our analyst picked up was that the major motivation for this business' growth, why the customers buy it on the margin is environmental. Heat exchangers are a way to essentially recycle heat that otherwise would be dissipated in industrial process. Think about the amount of air conditioning that goes into the vast numbers of data centers around the world that are growing like weeds. What if this company could get a bigger piece of that as part of its energy recycling rather than just run an air conditioner to suck up the heat, you could actually recycle it into something else, and that's the opportunity this company has. But on the surface, it looks just like a boring industrial company, and that's a matter of having done the work for more than several years. Understanding when one of these comes up. "Okay, what are the right questions to ask? What should we be looking for?" And we spent an awful lot of our time on this one in ESG. It's certainly not a few lines at the end of the write up. It's the reason to buy the stock.

Patrick: Yeah, and maybe I'll chime in with another example that I've worked on and other members of the team have worked on, because a lot of times you have both risk and opportunity at the same company. So going back

to Ingredion, which used to be known as corn products, it makes high fructose corn syrup. That's probably not something that is going to score favorably on an ESG screen in terms of both demand trends impact things of that nature, but Ingredion is potentially going be one of the major players in alternative proteins. We're a value shop, we're probably not going to own beyond meat, but certainly we do see a growing market for alternative proteins. We own Tyson, we own a chicken company that approaching company and major one doing beef, chicken and pork. And they're moving heavily into that space as well. And so that's a trend we see in society, is we see Meatless Mondays, we see the impact of less meat consumption, the negative impact from beef especially. And so we can see as well as anybody the demand for alternative protein. So a company like Ingredion, they make a pea protein isolate. They're going to be a major supplier to the companies making meatless burgers. And I know that some vegetarians think we shouldn't use the word burger on a meatless thing, but that's the way to get consumer consultants. Burger King has said that the impossible whopper is materially adding to their customer base that offers families an option where maybe more members of the family can find something they like on the menu, find something they're comfortable eating. And so at a company like Ingredion, we've got this high fructose corn syrup issue on one side. We've got this pea protein isolate on the other side. And by the way, the more they do with pea proteins, the more pea starches come out that provides a better nutrition element than a corn starch for both human consumption, and it also might be a good addition to dog foods. That's a growing business opportunity for them. So there's a lot of ways that plays out. And, you know, we've spent seven or eight hours probably talking to Ingredion about different parts of their business. And the ESG part is just another part of the business analysis. Another part of the opportunity on that when we look about potential growth in the financial statements and it really is key, but we need to be thinking about both the risks and the opportunities out there.

So, Jim, when you think about a value firm, a lot of people might have stereotyped us as focusing more on the G, on the governance part of things. But maybe I think you've got some interesting thoughts is maybe how this has evolved over the last couple of years in terms of where you might have predicted the emphasis and where we'd spend the time on ESG issues and how that's evolved over the last couple of years.

Jim: So I'm sure many investors are going through a similar process now of defining what this means and how to work with an analyst team on it. It's something we've thought about a lot. When we started formally addressing this after becoming a signatory, governance was the easiest. And we found when an analysts had to report in ESG section or an ESG disclosure, governance was the easiest one to report because these are things we've talked about for years as value investors, management boards, compensation systems, things like that. The E and S parts, it's easy to see them on some companies, but as I said before, that doesn't mean you don't look for them on others. Sometimes the answer is not terribly relevant. Environmental with a bank. We do an international fund. If your bank is in Norway where it's an oil producing country, it does matter.

Patrick: Although I'm going to jump in here as one of the people that covers banks because certainly when I write up JP Morgan or Citigroup and there E impacts, we're looking at who they lend to. We're looking at the kind of projects they lend to. There's disclosures like palm oil disclosures, there's child slavery disclosures, there's money laundering. There's a fair amount even on the E side. And maybe it's not it's their own operations, but it's how they impact other people's businesses. That's one of the things that I think we've gotten a lot better at to Jim's point is maybe two years ago, I would have said, "oh, bank, what are we really to do with environmental impact there?" But now all of a sudden we're looking at those metrics. And I want I want to give some major praise to the major U.S. banks here, because they've got employee hours traveled. They've got, you know, miles traveled on airplanes. They've got impact from that. They are studying and reporting on their impact. So not to distract from your train of thought there, but one of the things we have learned is exactly how many different places we can apply these principles.

Jim: I think that's a great demonstration. I'll come back at you, Patrick, and suggests that you're going to do the taste test on the Ingredian products, my role as research director only goes so far. But what you just heard was a demonstration of previously how we might have thought about things. And I was demonstrating that I was still in an old school I'm thinking about banks. And Patrick is much closer to the banks as part of the analyst team on that sector. And he just demonstrated why I was short sighted on that. We've learned that in many industries by actually doing this. I just learned something here on the podcast so we get better and better at this. It's been a

two year process and I don't want you to edit that out because I made a very important point about how we learn.

Patrick: All right. So maybe wrapping up here a little bit. I think one of the goals for Brandywine's podcast series on ESG is to put investment professionals in front of the microphones to show you that we're actually doing this on the teams. Our plan for the series is to say, "how do we do this in quantitative products? How do we do this? And global fixed income products? How do we think about it internationally perhaps versus in the U.S.? What are some of the major environmental issues?" So we hope to make this a series. We appreciate your listening to this. And if you have requests for future topics, feel free to reach out.