Insights
Fundamental Value Equity

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Evolution Rather Than Revolution — Integration of ESG into the Fundamental Value Equity Investment Process

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The Fundamental Value Equity team at State Street Global Advisors has a long history of ESG investing. The team has run a number of exclusion-based mandates since the 1980s, while our long-standing fundamental investment approach and governance activities involved implicit consideration of ESG issues across our broader suite of products. This paper explores the evolution of our process in a changing environment.

The Rapidly Evolving ESG Landscape

We have seen an explosion of interest in ESG issues in recent years. Increased awareness has been driven in part by the United Nations adoption of its Sustainable Development Goals in 2015 and the UN Paris Agreement which was signed in 2016. Across the globe, the heightened interest in ESG issues has helped shape the investment landscape. There have been significant flows of funds into products that have been branded as 'green', 'sustainable' or 'ESG'. However, such terms can be thrown about with some abandon, which can make it difficult to compare companies and products. As a result, concerns about the process of 'greenwashing', the misleading of the public/investors about sustainability credentials, has grown.

Regulations Pace Change

The enhanced public interest in sustainability has also helped drive a raft of new regulation, particularly in Europe. For example, in March 2020, the European Union (EU) released an action plan for financing sustainable growth. This plan incorporated sustainability into the assessment of suitability of financial instruments. It also called for an EU classification system for sustainable activities, the 'EU Taxonomy'. Although level 2 is still not finalized, the taxonomy was published in June 2020 and becomes effective on 1 Jan 2022 for climate change adaptation and mitigation. In June 2020, the US Department of Labor published proposals that aimed to clarify its position; that only financially material ESG issues should be factored into investment decisions.

While this interest around ESG investing in more recent years has created new challenges for investment managers, pension fund trustees and advisors may also face increasing legal requirements around ESG integration, such as more explicit responsibilities under the EU IORP II Directive. New disclosure rules will also likely increase pressure on investee companies to improve their own disclosure.

Shift in ESG Approaches

Traditional approaches to ESG investing historically tended to gravitate towards exclusion — screening out companies or sectors deemed unethical or morally unacceptable (e.g. stocks associated with military weapons, tobacco or gambling). Over time, ESG strategies evolved to become more integrated or inclusion-based — managers would select companies or sectors from their investment universe based on a combination of ESG factors and financial analysis. More recently, a hybrid approach has emerged — integration as the core process with exclusions in commonly accepted sensitive areas.

Our response to these developments has been to be more explicit about how we integrate ESG analysis into our investment approach — evolution rather than revolution.

Following due diligence on a number of external ESG research providers, we engaged Sustainalytics to assist with our efforts around ESG integration. That has been further buttressed by incorporating data feeds for R Factor, a proprietary ESG scoring methodology developed by State Street.[1]

Our Approach — Bottom-up, Value-driven

The approach of the Fundamental Value Equity team to ESG integration can be broadly summarized as follows:

- ESG company ratings feed directly into our screens and stock templates at the outset of our investment process. Company ESG performance and material risks will be flagged to our analysts before research commences on a potential investment case.

- Our analysts will not typically exclude companies on the basis of a low or challenged ESG score.[2] Instead, we seek to understand the issues at hand and their potential impact on our long-term financial assumptions around the business.

- Where material ESG issues are uncovered, the team engages directly with company management and our Asset Stewardship team to put forward our views on the issues to be addressed.

Our investment process can be simply described: we seek out stocks where the current market valuation underestimates our assessment of the long-term economic earnings power of the business (ROIC). Our process requires robust assumptions around the sustainable operating profitability of a business as well as the capital required to support those assumptions. As fundamental analysts, we are interested in any material ESG factors that could positively or negatively influence these metrics.

We systematically incorporate ESG data into our investment decision-making processes to help isolate specific issues for further consideration. We continue to believe that assessing the impact of material ESG issues on the future earnings power of a business should be part of any fundamental analysis of a company. We consider company ESG attributes from a bottom-up, fundamental perspective, and each analyst looks to capture material ESG observations in their research notes in the course of evaluating a company.

Having assessed a business and determined that it is undervalued relative to our estimate of long-term economic earnings power, we are prepared to invest, even if the business currently carries a low ESG rating.

ESG Integration in Practice

Although beset of late by troubles related to the impact of COVID-19, the airline industry serves as a good example to see how ESG considerations can impact a potential investment case. We have come to recognize that key to long-term value creation in this industry are relative cost competitiveness in markets served and asset (aircraft) productivity. We believe that these key long-term success factors have become even more important during the pandemic and will likely be characteristics of those companies that emerge as structural industry winners from the crisis. Key inputs into our modelling assumptions in the sector include operating margin (a measure of cost competitiveness) and capital allocation (a driver of asset productivity). Let's consider the following ESG factors in that context:

- **Carbon Footprint** — can the airline demonstrate declining emissions on a per passenger basis? What does analysis of the current aircraft fleet and future order book tell us about future fuel-burn? These are issues that will impact on group productivity, operating margin and regulatory relationships.

- **Human Capital** — how are employees organized and engaged? Are operational employees represented by collective bargaining or other employment methods? Is the industrial relations environment sufficiently stable to drive productivity and a low risk of disruption? These issues are critical to operating performance and profitability in a capital-intensive business. Our normalized financial assumptions on specific airline investments reflect our thinking on these types of issues and incorporate the frequent overlap between fundamental and ESG analysis.

ESG Integration and Stock Performance

Central to our integration efforts is the belief that consideration of ESG factors is complementary to our investment process rather than something more transformational.

Uncertainties associated with matters designated as environmental, social or governance issues face all businesses. For example, despite the news emanating from China in the early months of 2020, few accurately predicted the impact of COVID-19 on the global economy in the following months. On top of the human cost, the pandemic hit the stock prices, short-term earnings and liquidity of many businesses. Responses to key stakeholders such as customers, suppliers, employees and providers of capital have varied. However, for many businesses that had the cash flow generation, business models and balance sheets to navigate through this difficult time, our assessment of their long-term earnings power did not materially change during this period. With the crisis still ongoing, a big question facing all investors is how strong do those balance sheets, business models and cash flows need to be?

The pandemic reinforced the fact that we cannot accurately predict the future. As custodians of capital, we seek to consider the key risks facing companies (whether ESG-related or other) while seeking to pay a fair price when taking a stake in a business. Our preference is for high-quality businesses with robust business models and strong balance sheets, but we also seek a valuation that we believe provides a margin of safety. However, risk management is not just about managing the downside. Consistent with other crises, the large short-term swings in stock prices provided us with the opportunity to take stakes in companies where we believed the long-term fundamental earnings power of the business was not reflected in valuations.

Unfortunately, in much of the literature and debate around ESG investing, there is rarely reference to the primary determinant of future investment returns — starting point valuation. A portfolio of companies with leading ESG characteristics is likely to provide disappointing future returns if purchased at inflated valuation levels. Academic studies in this area seem supportive of this viewpoint.[3]

Firm-wide Commitment

Ronald P. O'Hanley, Chairman and CEO of State Street Corporation, said as long ago as 30 January 2017, *"As active stewards, we represent the interests of our clients who are the actual owners of the assets that we manage."*

Growth in index-based investing has resulted in large asset managers accumulating stakes in companies, often unmotivated by a fundamental understanding of the underlying business. It is often perceived that engagement between company management and these asset managers is thus of limited value. We look at this issue differently: the systematic nature of buy and sell decisions means that engagement through proxy voting and meetings with senior management and board members is a key opportunity for these investors to have influence. Although a large part of group AUM is index-based, State Street Global Advisors adopts an active approach to engaging with company management teams. The Fundamental Value Equity team contribute to this company-wide active engagement with companies.

We engage with our portfolio companies to share views on the risks and opportunities that may affect returns over the long run:

- The team collaborates with the central Asset Stewardship team to engage with management teams and contribute our perspectives.
- The team works closely with the central Asset Stewardship Team on proxy voting.

Example of Proxy Voting Collaboration Involving Executive Remuneration at a Global Technology Firm:

In 2016, we identified that the business had neither provided us with monetary quantification nor substantive disclosure around option awards to the CEO. We also noted that the awards in the previous two years had subsequently been valued at in excess of $30 million per annum. After engagement with the company, we voted against the CEO compensation motion at the 2016 AGM. In 2017, 2018 and 2019 we continued to encounter the same issues and so continued to vote against CEO compensation. We also maintained engagement with management on the issue. In 2020, the company announced a substantial reduction in CEO compensation. but again disclosure around remuneration metrics was poor. While acknowledging the reduction in compensation was a step in the right direction, we remained concerned with regard to specific disclosure on this issue so abstained on the CEO compensation vote.

"Ultimately, we have a fiduciary responsibility to our clients to maximize the probability of attractive long-term returns — and will never hesitate to use our voice and vote to deliver better performance. This is why we are so focused on financially material ESG issues."

Cyrus Taraporevala, President and CEO of State Street Global Advisors, January 2020.

Conclusion

We have made significant progress in developing and formalizing our ESG integration process in recent years — we now use a variety of tools and data to highlight ESG issues, risks and opportunities. We seek to incorporate them into our valuation of companies. However, our stock selection and portfolio construction remain firmly rooted in our valuation discipline.

Endnotes

1 R-Factor™ — State Street developed an ESG scoring methodology, R-Factor™, to address market infrastructure challenges around ESG data quality. By offering companies a transparent road map for how to improve their ESG practices and disclosures, the aim is to build more sustainable markets. The R-Factor score draws on data from four ESG data providers and leverages the Sustainable Accounting Standards Board's (SASB) widely-accepted transparent materiality framework, as well as its corporate governance codes, to generate a unique ESG score for listed companies. We currently score more than 6,600 issuers and are continuously expanding our coverage universe.

2 The State Street Global Ethical Value Strategy is constructed with reference to both suitable investment opportunities generated by our fundamental research platform and explicit stock exclusions in a number of areas such as Defence, Tobacco, Fossil Fuels and Human Rights. An Ethical Committee comprising both external clients and internal members is charged with formulating restriction guidelines in areas of particular concern to the underlying client base. These guidelines are translated into specific stock exclusions with the help of an independent third party ESG provider and implemented on a pre-trade basis.

3 Empirical Research Partners (2014). "Perspectives on Socially Responsible Investing". Asness, C. (2017). "Virtue is its Own Reward" Cortez, M., Silva, F., and Nelson Areal (2012). "Socially Responsible Investing in the Global Market: The Performance of US and European Funds." International Journal of Finance & Economics, Vol. 17, Issue 3.

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- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 31 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.15 trillion* under our care.

* This figure is presented as of September 30, 2020 and includes approximately $80.51 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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