Investment Management

For Professional Investors Only

PHILOSOPHICAL ALIGNMENT ESG/VALUE

The philosophy of a value investor and the principles of ESG integration harmonize. ESG issues, in our view, are a subset of business issues potentially impacting the valuation of a company. As such, our investment research would be incomplete without appropriate consideration of material ESG issues. ESG integration is therefore about fully understanding the value opportunity at stake for a given company.

Below are some of the core philosophical beliefs of a value investor, and we highlight the inherent compatibility with ESG integration.

Value Investing		ESG Integration
Temporary Difficulty		
Investments are experiencing temporary difficulty	⟷	ESG controversies can be a material driver of temporary difficulty
Opportunity		
An opportunity to buy a good business 'on sale'	⟷	ESG laggards may have an embedded opportunity to improve
Long-Term Perspective		
Requires patience / long investment horizon	⟷	Many ESG issues require a long-term perspective
Alpha Potential		
Earnings recovery = source of alpha potential	⟷	ESG improvement = source of alpha potential

1. Value stocks are, by definition, experiencing some kind of difficulty; hence they trade at a discount to the rest of the market. The possible reasons for a depressed valuation are numerous, including that the company faces ESG issues or has mismanaged its exposure to ESG risk. It is through fundamental bottom-up research that we seek to determine which companies' difficulty (ESG or otherwise) is temporary rather than permanent and whether we can see a path to earnings recovery.

2. Once the source of difficulty has been identified, value investors must assess the embedded opportunity. Value investing is an opportunity to buy a good business 'on sale'. Usually, the opportunity exists because the business is undergoing a temporary setback, such as declining earnings. For those value stocks that are also ESG laggards, part of the investment opportunity is the potential for improvement in material ESG considerations. We therefore focus on the future; the rear-view mirror tells us nothing about a company's potential. In this way, we do not believe in "ESG stocks" or "good" and "bad" ESG companies. What matters is the embedded improvement opportunity, ESG or otherwise.

3. To realize earnings improvement, a value investor must often exercise patience, as recovery may take place slowly over time. That is why we typically hold stocks for a minimum of 3-5 years (if not longer) and take a long-term forward-looking view of the issues facing a company. This is naturally aligned with the time horizon over which ESG issues may play out. For example, a long-term investor must consider the risks that climate change poses to many industries that need to undergo costly transitions to pivot legacy business models toward activities that facilitate the energy transition.

4. Earnings recovery is important for value investors because it can be a key source of alpha potential. We look to improvement in business fundamentals as a source of excess return. Assuming ESG issues are financially material, it makes sense that ESG improvement could be a material driver of this recovery. Through our own proprietary research, we examined the relationship between ESG scores and investment performance and found that companies with improved ESG scores tend to outperform stocks with lower improvement in their ESG scores.

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