RESPONSIBLE INVESTING AT
BNY MELLON INVESTMENT MANAGEMENT

How Newton Makes ESG Part of Every Investment Decision

By Sandra Carlisle
Head of Responsible Investment
Newton Investment Management

"Sandra Carlisle leads a dedicated research team focused on environmental, social and governance issues."

EXECUTIVE SUMMARY

Responsible investing covers a wide spectrum of investment approaches. The earliest forms of responsible investing employed negative or positive screening in the portfolio construction process. Negative screening excludes investments that are incompatible with an investor's ethical values regarding, for example, alcohol, tobacco or firearms. Positive screening seeks to invest in enterprises that have, for example, best in class water use policies or progressive labor practices. Other strategies align with an investment view that environmental, social and governance (ESG) factors should be incorporated into investment analysis and that positive ESG factors might provide a competitive advantage and help companies outperform over the long run. More recent approaches include investments that are meant to have a positive environmental or social impact, such as "green" bonds; "social impact" bonds aimed at, for example, reducing the rate of recidivism in prison populations; or private equity investments meant to generate a positive return as well as a measurable social or environmental impact in areas as varied as healthcare, education, job creation or water remediation. These approaches are evolving amid a broader industry debate about what constitutes investment risk and opportunity in a new global financial landscape, and how methods of investment analysis should adapt.

At BNY Mellon Investment Management, many of our affiliates are signatories to the United Nations' Principles for Responsible Investment (PRI) and are actively involved in responding to growing client interest in a range of responsible investing approaches reflecting our multi-boutique model's different styles and investment philosophies. As part of our continuing series of features about responsible investing at BNY Mellon, we spoke with Sandra Carlisle, Head of Responsible Investment at Newton, who leads a dedicated research team focused on environmental, social and governance issues.

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Why does Newton emphasize ESG factors in its investment decisions?

We are long-term global investors and our perspective informs our decision-making process. We manage our clients' money with a focus on risk-adjusted return and the view that if we don't know the risks that we're taking, we won't know the return we are getting. ESG factors represent investment risk so we would be remiss in our responsibility to our clients if we didn't look at them.

Mission-based investors have long wanted their investment managers to exclude certain sectors from their portfolios, but an exclusionary approach can raise issues of fiduciary duty. These investors' concerns, in turn, compel investment firms to look more closely at some of those difficult sectors. Certain sectors raise complex issues that we need to be able to respond to. Since the financial crisis, there's been a greater understanding by investors that factors they may not have previously considered relevant to companies' financial performance actually are important.

Responsible investing has been a prominent feature of the investment management landscape in Europe for some time. How has Newton kept pace with European investors' interest in integrating ESG considerations into its investment process?

What you find increasingly in Europe is an attitude that asks "why wouldn't you look at these types of risks," rather than "why would you"? Newton has been that engaged in responsible investment since the firm was founded in 1977. At that time, Newton primarily managed U.K. equities so the focus was on U.K. proxy voting. The firm's leaders were concerned about how those companies governed themselves, their business strategies and with making sure the business was run in the interests of minority shareholders. This approach was quite innovative in 1977, and it predated the modern U.K. governance code, which was introduced in 1992. Over the last three-and-a-half decades, our commitment to responsible investment has evolved. Our concerns are the same today, but our understanding of risk is far more sophisticated.

"We've grown more sophisticated as we've become global investors who are active in markets far from home."

How does that increased sophistication manifest itself today? What steps do the investment teams take in regard to ESG?

The level of sophistication is greater today because we're in a much more regulated environment with codes of practice that have evolved significantly. Some markets like the U.S. have gone down a regulatory route in response to market failure as in the case of Sarbanes-Oxley. Other markets such as the U.K. have adopted a "comply-or-explain" approach, where you have a code of practice and you can choose to comply or explain where and why you can't. The top-down regulatory framework is much more rigorous than in 1977.

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We've also grown more sophisticated as we've become global investors who are active in markets far from home. When we were invested mostly in the U.K., the companies were on our doorstep and we had a pretty clear line of sight into their activities. Now we're invested in Asia and emerging markets and North America. That global presence brings different levels of complexity, different governance regimes, and different levels of disclosure and transparency. To address this increased complexity, we've expanded the responsible investment team. Its five members are experts in environmental, social and governance issues in the same way that Newton's global sector or regional analysts are experts in energy or consumer goods or banking, for example. We have this specialist expertise in-house because we believe this is a very specialized and complex area of investing. Like everything in the market, the more you look, the more you find; and the more information you have, the better the decisions you can make. We think that having this expertise in-house gives us more ability to develop a sophisticated and nuanced risk assessment that we believe will give us an investment edge.

Why have you developed an internal research team, rather than relying on third parties as many of your competitors do?

While we use third-party and broker research, in no way do we rely on it for our investment decisions. Some of the specialist and third-party data is very good and it informs us, but we prefer to rely on our own ESG analysis and make our own risk assessments for all the companies we consider.

How does this team play a role in the making of investment decisions?

At Newton, investment team members are either portfolio managers or researchers. The responsible investment team members are researchers, so we sit with the rest of the investment team. We sit on the same floor, which is not the case for ESG researchers at many of our competitors. We go to the morning meeting and hear the investment stories every day. It's a two-way process where an analyst may come to us and say, "here is something we need you to think about," or we might say "here is something we think is a risk that we need you to think about, or think more deeply about than we had before." ESG issues can be brought into the investment research process formally: Before any stock goes onto our global recommended list, a formal ESG review must be completed. They can also be raised informally, as in a discussion that leads to our coming up with a view.

A big part of our process involves engagement, which is a far more common approach in Europe than in North America. Engagement means meeting with a company we're invested in to raise issues of concern and discuss and explain why we believe the company should be concerned too. We also explain why we'd like to see changes in the company's process and behavior. It's a very active process where we may both give the company credit for doing things that are sector leading as well as hold them to account and say, "this other area is far from best practice and it creates risk for us as investors, so we need you to change what you're doing."

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What expertise do the members of the responsible investment team bring to their roles at Newton?

It's a mix. I came from the sell side where I set up one of the first ESG departments in the City and then moved to the buy side. Our governance specialist has been here for 17 years and that's a very specialized career path. Our other members come from specialist and consultancy teams focused on ESG.

What differentiates you from similar teams at other firms?

We're totally integrated with the research process. We don't sit in a box, which is quite often the case elsewhere in the industry. That's a key differentiator for Newton. Lots of investment houses are trying to figure out what ESG integration means, but that's never been an issue for us. We've always been an integral part of the investment process.

There's a board-level commitment to making ESG a part of the investment process. We don't have to provide the Newton board with a rationale for what we're doing. They get it. It's done as a matter of course. There is also a depth of thought that goes into the work that we do as we have to justify our views to Newton's sector analysts. We put out a quarterly report on all of our engagement activities and we publish regular thematic ESG research. We also don't abstain from voting. We vote on resolutions for every company we own and we always vote for or against company management and never abstain. Some of our peers may have abstention rates higher than 20 percent. Our votes are also reported very transparently to clients and we explain how we voted and why.

Have there been situations where a very compelling financial case for an investment has been trumped by concerns raised by the ESG team and an investment didn't go ahead for those reasons?

On several occasions we've put out notes on companies and the portfolio managers have taken our advice and not invested in companies that later had scandals around the issues we identified. Also, when we give a company a low ESG score across the board, we have another round of discussions with the analysts and investment teams around risk-adjusted return potential before an individual fund manager can make a decision. What we don't do is tell portfolio managers that they cannot invest in a company that is rated low on all ESG factors. That decision is theirs and is based on their assessment of the risk-adjusted return. Where the rating is low and the risk is high, we use engagement to explain to the company how it falls far short of what we would like to see and how it raises risk for us as a long-term investor.

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The point in time at which the distinction between ESG investing and "mainstream" investment disappears seems much closer in Europe than in North America. What do you see as the future for ESG?

It depends on the market and the investors. In northern Europe, we're pretty close to that point. You won't get through the RFP process unless you can show that you're considering ESG factors. Consultants also tell us that ESG must be a fundamental part of our research process. The world is shifting quite far in certain markets, but the U.S. is quite a long way behind. Part of the reason is the varying levels of regulatory drive in different markets. The U.K. introduced the Stewardship Code in 2010 which commits signatories to a set of principles around responsible investment. It uses a comply or explain approach, but it's really no longer considered acceptable not to comply. Japan has also introduced its own stewardship code. The U.S. isn't even having a debate about doing this.

I think that before the financial crisis, the market looked at upside. The crisis focused attention on the downside. I can't say that our ESG work creates alpha but I can show that when things go wrong, whether in the financial crisis or the BP Macondo oil spill, there can be tremendous losses of value. That's made investors shift their focus onto the kinds of risks we pay attention to.

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