Mondrian
INVESTMENT PARTNERS

A Value Approach to ESG: The Mondrian Perspective

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Executive Summary

- The inclusion of ESG factors is essential in understanding risk-adjusted returns.
- Implemented in a systematic and consistent manner, ESG incorporation can be effectively integrated into a value investment philosophy.
- Analysts adopting a holistic approach, rather than ESG specialists operating in silos, creates greater efficiency and context.
- Mondrian's long-term, scenario-based approach is particularly well suited to the integration of ESG factors.

Introduction

As a long-term value manager Mondrian Investment Partners believes that carrying out analysis which captures all potential material risks and opportunities. Understanding and integrating the impacts of ESG factors is a natural extension of our long-term modelling.

As debate surrounding the incorporation of ESG factors has become more mainstream, we have received a range of questions looking to understand our views; should we separate the roles of portfolio manager/investment analyst from ESG-specific researchers; what weight should we place on a company's disclosure; and how compatible is ESG with differing investment styles?

Widely divergent approaches to the incorporation of ESG in the investment process have been known to be described as 'integration'. In this paper, we will focus on defining our understanding of the term. We will then explain why we believe our holistic, integration-based approach to ESG analysis is a particularly effective means of assessing the impact on intrinsic risk-adjusted value that such factors present.

As part of this discussion we will look at the compatibility of ESG with a value investment philosophy and the role of engagement in the broader investment process. We will describe and demonstrate how Mondrian applies this risk-based approach in our firm-wide equity investment process.

ESG and Value Investment: Our Case for an Integration-Based Approach

The willingness of value investors to take a position in a broad range of companies and industries – including those that typically score very poorly with regards to certain ESG characteristics – has been taken by some to mean that a value investment philosophy is incompatible with the incorporation of ESG factors.

However, this needn't be the case. In advocating for an integrated approach, we argue that all material factors that could influence a company's valuation – as determined by its future cash generation and shareholder returns – should be rigorously analyzed and incorporated as part of an in-depth research process.

Considerations stemming from environmental, social, and governance concerns must, where material, be included in this process. Taken not in aggregate but as individual concerns, they can be understood in the context of the company's specific financial and operational situation.

The result of this risk-based approach is that, much like any other strategic, financial or regulatory risk incorporated into an equity valuation, the presence of large ESG-based risks need not preclude investment, provided they are adequately discounted in the market price.

In contrast, an approach to incorporating ESG that aggregates concerns together into backward-looking ratings – layering this over an investment decision that has failed to otherwise address these factors – is open to the loss of specific details that could be important in understanding the long-term outlook for a particular company. For example, minor issues that are inconsequential from a risk and return standpoint may become inflated, and undue influence may be given to the extent of ESG disclosure. Further, the aggregation of ESG concerns makes it challenging to distinguish between and then incorporate factors producing shorter and longer-term impacts, and to appraise the range of outcomes that are possible from a given ESG factor.

Though environmental, social and governance concerns can manifest over short-term time horizons, it is clear that many increase in their impact on a company and its performance over much longer periods, perhaps extending years, even decades into the future.

Such long-term effects can only be effectively captured in valuation analysis when the investment horizon and valuation methodology itself is sufficiently long enough to cover the relevant duration in question.

When such long-term factors are at play, and given the complex and nuanced ways in which ESG risks and opportunities influence the future cash generation of individual companies, effective analysis of a range of potential future scenarios is critical.

Engagement is an important component of a fundamental investment process and where possible, should incorporate management interactions to discuss business strategy, as well as material environmental, social and governance concerns. Ideally such interactions should be conducted on a regular basis to ensure knowledge is up to date and reflective of changes to management initiatives, governance and strategy over time. We prefer a one-on-one approach over collective engagement approaches, as it ensures Mondrian's particular concerns are discussed.

Finally, we would argue that this process is best undertaken by the analyst, rather than an ESG-specific function. Understanding the future materiality of each ESG risk and opportunity must be a forward-looking process and for this to be possible, the analyst must have a granular understanding of the company and its operating environment, as well as insight into the company's intended future trajectory with respect to each issue at play.

Research gathered by ESG-specific teams can be useful in building knowledge on a broad range of issues, however such knowledge is of limited value when presented or analyzed in a vacuum. Ultimately, the judgement required to properly contextualise, understand and forecast the impacts of ESG risks and opportunities on a company – and how these will translate into the future cash generation of the company – is best exercised by the analyst.

Mondrian's ESG Methodology

Mondrian's approach to incorporating ESG factors is aligned with our belief that strong fundamental company research demands the analysis of all material factors that may influence a security's valuation. In practice, our methodology exhibits the following characteristics:

Bottom-up Approach

Highly detailed due diligence is carried out on all potential investments, involving both meeting with company management and carrying out extensive analysis of financial statements to inform our understanding of the business model, long-term strategy, broader operating and regulatory environment, corporate governance standards and business practices. This process allows analysts to move beyond industry level issues to develop granular insights into company-specific ESG risks and opportunities.

Long-term Approach

Mondrian analysts forecast 5 to 10 years of dynamically integrated financial statements in detail, supported by segment level analysis; thereafter, long-term growth rates are applied to earnings to extend the dividend stream out over the very long term. This approach, in place since the founding of the company, is well suited to capturing the impact of ESG risks and opportunities which are often long-term in nature.

Scenario Analysis

By separately modelling base, best and worst case scenarios Mondrian analysts capture a range of possible outcomes for potential investments. This process is well suited to incorporating the impact of ESG risks and opportunities which can be hard to capture in a base case analysis alone, or by using a backwards-looking 'earnings multiple' valuation approach.

Comprehensive Program of Meetings

Meeting with senior company management and board members is an integral part of Mondrian's due diligence and ongoing monitoring process. This is also an ideal forum for direct engagement on areas where Mondrian has specific concerns. In 2017, Mondrian portfolio managers and analysts conducted close to one thousand meetings and calls with company representatives.

Responsibility for ESG Analysis Rests with the Analyst

Incorporating the financial impact of material ESG risks and opportunities is an integral part of any company valuation. The impact of ESG issues on individual companies is generally complex, and subjective judgement is required in their analysis. This analysis is best conducted by those with detailed knowledge of the company and its operating environment, therefore Mondrian believes this work is best completed by the analyst rather than a separate ESG-only analyst.

Explicit and Systematic Documentation of ESG Analysis

Mondrian's approach to risk and return analysis for ESG factors is identical to our approach to all fundamental financial analysis, and our ESG research continues to be seamlessly incorporated into our company valuations and the overall assessment of the risk and return opportunity a stock presents.

To help make this process more transparent, all Mondrian equity analysts complete a proprietary ESG Summary Report which systematically articulates the key ESG risks and opportunities to which the company is exposed. Analysts provide commentary on each of the issues and include a study of how each factor has impacted the valuation models across the base, best and worst case scenarios, and over the short, medium and long term. To support comparisons of ESG factors across companies and industries, analysts assign a rating to each factor to summarise the company's positioning both in absolute terms as well as relative to its industry and regional peer groups.

ESG encompasses many different approaches and motivations; we believe investors should apply a structured integration approach with an engagement process that is in line with their broader investment philosophy. These broadly held beliefs are embodied in Mondrian's investment process, and approach to ESG.

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