MONDRIAN
INVESTMENT PARTNERS LIMITED

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 has always believed in carrying out analysis which captures all potential material risks and opportunities; understanding and integrating the impacts of ESG factors has therefore consistently been part of our long-term modelling.

Though the term 'ESG integration' has only become commonplace in recent years, the incorporation of environmental, social and governance factors as part of broader fundamental investment analysis has been embedded in our approach for over twenty-five years, through the use of our multi-stage dividend discount model to analyse equities over a long-term time horizon.

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, and finally we will touch on how we take ESG one step further in a dedicated ESG investment product for those clients interested in emphasising ESG factors in portfolio construction using a principles-based approach.

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 analysed 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 analysed 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.

Stock Case Study: Gilead Sciences

Social factors

One of a number of ESG-related factors that influenced the valuation of biopharmaceutical company Gilead was the company's market-leading promotion of access to medicine. Voluntary licensing agreements in India, South Africa and China should, over the long term, increase Gilead's access to these countries' healthcare systems, which is reflected in the incrementally stronger growth forecast in the best case scenario of our company model. The potential risks around quality and potential for corruption stemming from the company's supply chain oversight were also analysed, with the worst case scenario assuming a major product recall on safety grounds over the medium-term.

Result: Risks and opportunities integrated across scenarios; BUY DECISION

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 programme 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.

Stock Case Study: Reliance Industries

Environmental factors

Our analysis of Reliance Industries, an Indian oil refiner and petrochemical manufacturer, addressed a number of ESG concerns. The company was heavily reliant on carbon intensive industries but had begun a process of diversifying away from these activities through the acquisition of a telecoms license and construction of a 4G network in what was an underserved region. This presented a significant investment opportunity, accentuated by the market's heavy discounting of the execution risk inherent in such a bold strategic departure. However, through direct communication with management and in-depth, detailed research, the Emerging Markets team gained confidence in management's approach.

Result: Risks deemed to be more than discounted in the market price; BUY DECISION

Industry Case Study: Clean Power Generation

Environmental factors

In certain regulatory regimes, 'green' generation has become increasingly cost competitive compared with fossil fuel electricity generation, prompting the International Small Cap team to identify an opportunity to invest in long-life, inflation-linked and cash-flow-generative assets. From a thorough review of the investable universe and in-depth stock-specific research, three companies exhibiting competitive differentiation in asset base, regulatory positioning, and strong, stable cash flows were added to the portfolio; Mercury NZ, Innergex Renewable Energy and Transalta Renewables.

Result: Increased long term exposure to renewable energy

Stock Case Study: Fujifilm

Engagement on Corporate Governance

In 2017, Japanese firm Fujifilm disclosed accounting issues related to inappropriate revenue recognition in the Fuji Xerox joint venture in Australia and New Zealand. The International Equity team then held numerous conversations with the company, including with the President, regarding corporate governance. While the share price decline provided us with an attractive entry point at a time when many other technology company valuations globally were becoming stretched, we engaged with the company in detail to ensure that we had confidence that it was making significant governance and oversight improvements to avoid similar issues in the future before building the position.

Result: Increased confidence in governance; continued to build position

Taking ESG a Step Further – the International Equity ESG Product

Mondrian offers a dedicated ESG investment product for those clients interested in a principles-based approach to emphasising ESG factors in portfolio construction.

Our firm-wide approach to integrating ESG factors is first and foremost a risk-based approach, but Mondrian also provides solutions for clients that would like to pursue principles-based capital allocation through the recently launched Mondrian International Equity ESG Fund, Limited Partnership.

Supported by the extensive ESG analysis decribed earlier in this paper, we do not need to default to external providers of backward-looking, aggregated metrics or ratings to determine the ESG product's portfolio construction, nor do we believe in benchmarking against flawed indices assembled in this manner. Instead, the principles-based capital allocation decisions of the International Equity ESG product are guided by our proprietary in-depth, fundamental, forward-looking research on ESG factors which is carried out by all equity analysts, who critically draw upon the research of external providers as a 'completeness check' to ensure that our consideration of significant ESG factors has been comprehensive.

Drawing on our substantial experience in the construction of value portfolios, three additional portfolio construction criteria are considered by the portfolio management team of the International Equity ESG product:

1. Holdings should normally meet or exceed a minimum threshold as assessed using Mondrian's proprietary ESG Summary Reports
2. Exposure to business involvements deemed unacceptable for the ESG mandate – presently fossil fuel extraction, weapons and tobacco – should be minimised
3. Positive consideration would typically be given to stocks with more favourable ESG characteristics where two or more companies exhibit comparable valuations

We would expect the International Equity ESG product to continue to exhibit similar risk and return characteristics to the flagship International Equity strategy. Mondrian is one of very few international value managers offering an ESG-specific product.

If you would like to discuss this paper or any of our products further, please contact us in London or Philadelphia.

Stock Case Study: Lloyds Banking Group

Principles-based capital allocation

Although Lloyds has provisioned in the recent past for the historical miss-selling of payment protection insurance, a fact that has prompted backwards-looking ESG ratings providers to look unfavourably on the ESG credentials of the firm, through our detailed due diligence process including meetings with company management, we were able to become confident that a material cultural shift has occurred, minimising the risk of future financial product safety issues. As a time-bar for claims has been fixed by the FCA, the risk of ongoing costs from historical misconduct is limited. Further, from a financial system security standpoint, Lloyds is systemically important for the UK, and as such maintains a high level of capital, which is further supported by its highly capital generative business.

Result: Forward-looking social factor analysis supported the investment case

Stock Case Study: G4S

Principles-based capital allocation

Whilst our analysis found the risk and return proposition of UK-based security services company G4S compelling, the portfolio management team of the International Equity ESG product concluded that management's improvement of risk controls has been to date insufficient to render the company suitable for inclusion on the International Equity ESG product. Given the company's persistent history of social-related issues, our assessment of G4S integrated into scenario analysis the potential for further difficulties.

Result: Poor track record around social risk factors and uncertainty of improvement resulted in NO-BUY DECISION

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