Schroders

Global Equities:
A focus on sustainability

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Introduction

At Schroders, responsible principles drive our investment decisions and the way we manage funds. From choosing the right assets to engaging with our investments, positive principles guide our actions. Our responsible approach isn't merely a recent attempt to follow market trends, nor is it separate from our mainstream investment processes.

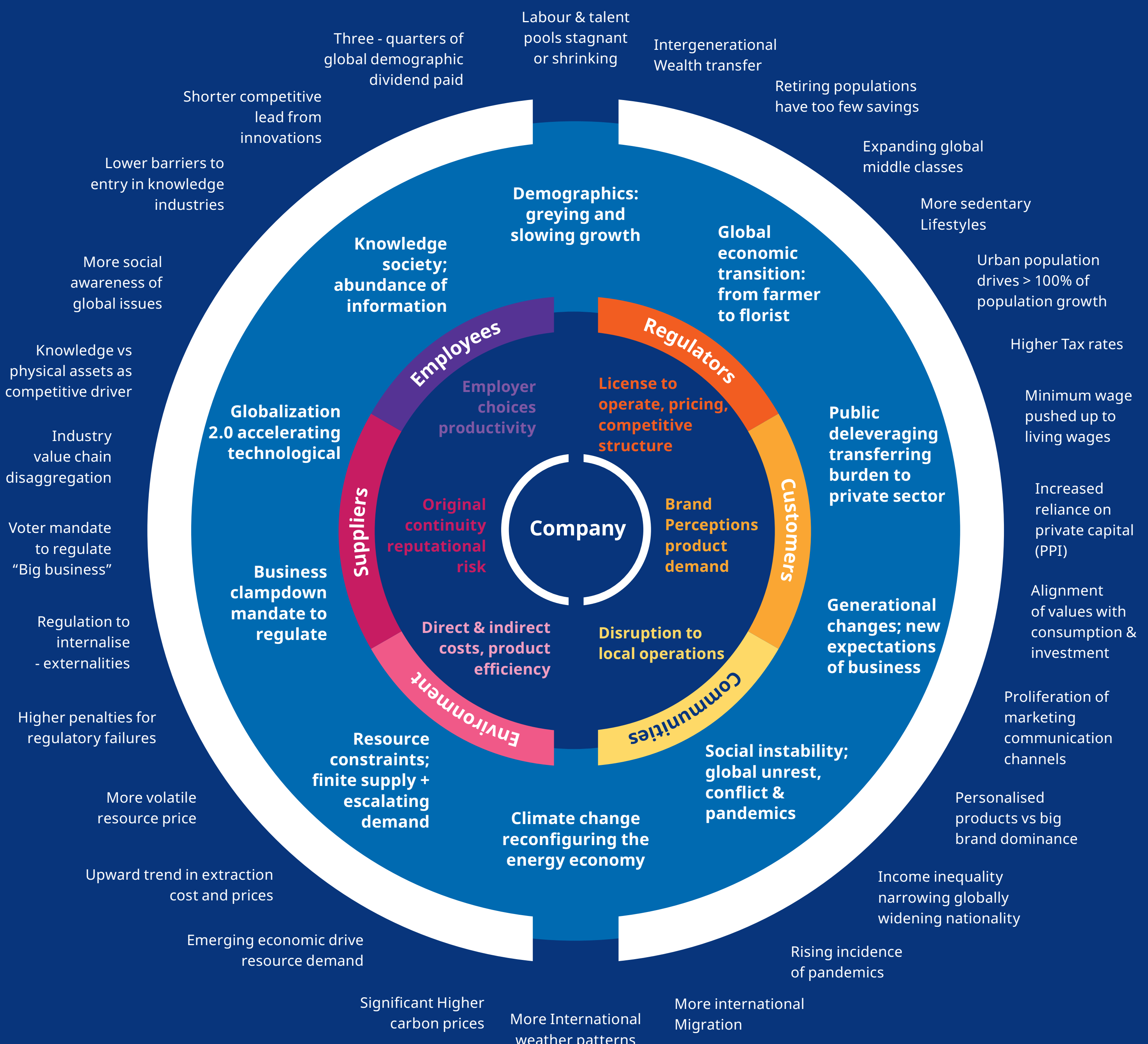
Our Global & International Equities team has long incorporated ESG considerations within our investment process primarily as a tool to improve our decision making. We believe it is a central component of our approach as an active manager to improve the outcomes of our long-term investments.

There is no single definition of ESG investing; nor should there be. Some investors focus on the durability of companies' financial performance, others on the fairness of their treatment of stakeholders, the contribution their products make to social and environmental challenges or their involvement in unsavory industries. The investment industry often has an unhealthy obsession with labelling things so that they can be easily categorized and placed in simple well-defined boxes. In recent years, we have observed an increasing interest in the ways in which we define and measure ESG factors as proxies for sustainability. However, defining and placing a "conclusive" ESG score or rank on a company or fund is inherently a backward-looking exercise. What matters most to investors is the forward-looking view.

Schroders has spent the last two decades working to continuously improve and strengthen our efforts around ESG integration and engagement. We have developed an industry-leading resource to ensure that all of our investment teams have the tools and framework to best understand the materiality of non-financial factors and how those factors can affect the durability of returns. This brochure outlines the approach utilized by our fundamental Global and International Equities team to embed the principles of sustainability within their investment process. Within the pillars of value creation in active management, we recognize that the process of ESG integration and engagement are integral components of seeking to manage, protect and enhance our clients investments.

Sustainability requires evolution and innovation

The long term performance of a company is substantially shaped by the sustainability of its business model and relationship with its stakeholders: employees, customers, suppliers, environment, communities, and regulators. The figure below illustrates the complexity of these relationships:



Source: Schroders. For illustrative purpose only.

Ultimately, sustainability reflects a company's ability to build and manage strong relationships with these stakeholders. Innovation is also at the heart of sustainability and companies seeking to maintain higher rates of return for longer need to ensure that they future-proof their business models. High returns and high margins are typically competed away over time. Well-managed companies that allocate capital intelligently and consistently adapt their businesses to the changing landscape to maintain their competitive strength are both rare and prized. Identifying those companies requires a research mind-set that is long term in nature and properly appraises the elements of sustainability. Our sustainability assessment is therefore anchored around the analysis of companies' abilities to influence and adapt to the pressures its stakeholders exert on their business, many of which are directly related to ESG factors or can be inferred from ESG analysis. We believe that the key to achieving sustainable returns is best supported through a process of integrating ESG considerations and engaging with the companies we invest with, as active owners – to improve the long term trajectory of returns.

An underappreciated source of alpha

We believe that the ESG performance of companies is inextricably linked to the delivery of long-term shareholder value. As long term investors, Schroders therefore consider it vital to appraise both financial and non-financial factors when analysing a company and its stock.

The appraisal of non financial factors, including ESG, contributes to a better understanding of a company's risk characteristics and return potential.

This does not mean that ESG analysis should dominate or override other factors, or, that companies with poor ESG qualities are un-investable. Rather, we should seek to understand and evaluate non-financial factors alongside financial drivers and assess how these affect the risk and expected returns from investing in a stock. Furthermore, active engagement with company management can improve social and environmental outcomes while also contributing to the sustainability of long-term returns.

There have been countless studies conducted, appraising whether incorporating ESG into an investment approach adds value. Recent academic studies have consistently shown that stronger ESG performances, measured in different ways, typically correlate to better profitability. Older studies have found that companies with high ratings for corporate social responsibility have a lower cost of capital and robust sustainability practices had better operational performance. Even the meta-studies that reviewed thousands of other studies have concluded that it is at worst neutral and in most cases adds value. This should not come as a surprise as it would only seem logical that companies that undercut their workers, hurt the environment or cheat their investors will inevitably pay a price for their misdeeds. It is not necessarily good governance that leads to outperformance, but poor governance clearly leads to underperformance.

Three pillars of value creation

Within active management, the primary ways in which managers add value is through their interpretation of information (research), the way in which they build the portfolio (portfolio construction and risk management) and through the process of engagement. ESG analysis is integrated into every strand of our approach – equity analysis; portfolio construction; portfolio analysis and reporting; corporate governance.

ESG integration in all steps of the process

Research

- Thematic research
- Training for analysts
- ESG Guidance document covering 170+ GICS sub-sectors
- Thorough analysis of risk and opportunities

Portfolio construction

- Fundamental risk score is a key input in determining position sizes
- ESG, management quality and transparency are primary factors for assessing quality and sustainability risk scores

Engagement

- Company meeting with analysts and ESG specialists
- Requests for change and disclosure
- Partnering with other investors and interest groups to exert greater influence

ESG embedded in the core philosophy

Schroders' Global Equity philosophy is anchored in identifying unanticipated growth and is based on the principle that companies delivering earnings above the level anticipated by consensus outperform the broader market. Through a process of fundamental stock research and analysis, combined with a detailed assessment of the fundamental risks of owning each stock, our investment professionals seek to identify those companies which will deliver positive earnings surprise (termed 'a positive growth gap'). The team anticipates such stocks will outperform as higher growth characteristics are eventually recognized within market consensus expectations. The team's analysis is forward-looking, with a significant proportion of their appraisal based on a 3-5 year time horizon. Risk to the sustainability of longer-term growth is therefore a key consideration when determining the trajectory of longer term growth, and it is in this context that the evaluation of non-financial risks, including ESG factors, are central to both growth and risk expectations. We consider it vital that the lead analyst conducting the research and delivering the research recommendation defines and appraises the ESG factors that are considered material to the investment opportunity.

Process supported by central ESG resources

We also recognize the importance of dedicated resources targeted at improving the quality of this analysis. Our central ESG resource is a key part of this. We currently have a team of 11 in the area, reporting into Jessica Ground, Global Head of Stewardship and an investor with over 20 years of experience. Five analysts led by Andy Howard, Head of Sustainable research, look at ESG issues on a sector basis, three corporate governance specialists, and one dedicated client and reporting manager.

Next we provide a detailed explanation of how our Global Equities team and Schroders central ESG team collaborate to integrate ESG considerations into the three key pillars of value creation within active management.

I. Research

Our approach seeks to ensure that analysts consider and evaluate the risks and positive drivers of sustainability and ESG-related factors alongside more conventional financial analysis that underpins our Global Sector Specialist’s (GSS) stock research recommendation.

Alongside each stock rating is a narrative which describes the investment conclusion, return drivers, risks and ESG assessment together with the financials and valuation. Stock ratings, analysis and ESG assessments are dynamic and reviewed around news flow and relevant events. Materiality will be subjective and will be based on the specifics of the business, its operations, industry structure, and geographies of the company being analysed.

Research efforts across the firm are supported by the central ESG team which provide ESG training to all existing and new investment analysts as well as producing multi-sector and multi-region thematic research on key ESG trends to educate investors, highlighting the potentially significant valuation impacts. They also serve as a resource for company specific ESG-related questions.

To further facilitate the ease of ESG integration within bottom-up analysis, and to ensure that ESG appraisal is systematically applied to stock and credit analysis, Schroders’ ESG team has developed a number of proprietary analytical tools which provide a framework for ESG analysis by the investment teams.

Sub-industry guidance document

In collaboration with our equity and credit analysts globally, the ESG team have identified and documented the key ESG risks and opportunities for 170+ subsectors, along with data points and metrics to help evaluate companies’ management of those trends. This document provides analysts with guidance and a structure for use in preparing for company management meetings analysis and appraisal.

Example

Movies and Entertainment

Companies that engage in producing and selling entertainment products and services, including companies engaged in the production, distribution and screening of movies and television shows, producers and distributors of music, entertainment theatres and sports teams.

Key trends

- The trend of more over-the-top viewing either via a Netflix or catch-up TV very much continues. While still a relatively small share of viewing it puts incremental challenges on the free-to-air (FTA) broadcaster model
- While many of the FTA broadcasters benefit from reasonably healthy advertising growth (UK and Germany in particular) they have been investing in content production, buying studios and/or invest in multi-channel-networks (YouTube TV channels in simple terms) to capture a younger audience and be in a better position if the traditional advertising model comes under pressure.

170+

ESG research guidance documents for 170+ subsectors

Stock references are for illustrative purposes only and are not intended to serve as a recommendation to buy or sell any security. The research views expressed are subject to change over time.

Key ESG Issues		Key Performance Indicators
Environmental		
Environment footprint	As distribution of music and entertainment continues to be accessed online, the sector will generate larger emissions and face increased energy costs as they use more data servers. The environmental impact of producing films and TV programmes may be material in terms of waste, and raw materials sourced to produce movie sets etc. There may also be environmental risks along the supply chain for movie merchandise Environmental impacts for movie theatres may include energy use	Energy consumption, CO2 emissions, supply chain policy
Social		
Primary Issue Cyber securitychain	The move to online media poses an increased cyber security risk to business' own operations (e.g. hacking). Protecting IP and the revenue lost through TV programmes, film and music being illegally downloaded is a material risk to the sector. Protecting customer data and payment details are also a risk	Data privacy policy, spending on cyber security, evidence of a team or director with responsibility for data security
Diversity and editorial policy	Managing diversity across the workforce is relevant to good human capital management but also addressing diversity across film, TV and music to reflect the customer base is relevant to future revenues	Diversity policy
Responsible marketing	Responsible marketing: choosing which advertisers to work with and be associated with. An absence of standards may result in reputational damage for clients and lost revenue. Sector leading companies have responsible marketing policies in place as well as editorial policies and guidance on the use of social media to minimise this risk Selling practices and marketing of the company's own services should also be covered by a policy	Responsible marketing policy, social media policy
Health and safety	Need robust health and safety practices to ensure the safety of production staff, actors and the public when filming films and TV programmes	Injury rates including frequency and severity
Governance		
Board Independence	What is the percentage of independent board members? Is the CEO/Chairman role separated? If there is a combined CEO/Chair, is there a Senior Independent Director?	% of independent directors on the board Average board tenure
Audit	The quality and reliability of the company's report and accounts are a key concern to investors. In addition the audit committee is responsible for risk monitoring and compliance across the business. The expertise and independence of the board members is key	Auditor tenure, audit committee independence, presence of financial expertise on the audit committee, ratio of non-audit to audit fees
Business ethics and whistleblowing	The company should have an adequate code of conduct, which includes anti-bribery and corruption	Publicly disclosed code of conduct, number of whistleblowing calls received, hours of employee training on anti-bribery
Remuneration	Are the long term incentives linked to business strategy? Does the bonus scheme have performance conditions attached? Are awards granted in cash or shares? Is total remuneration excessive relative to the sector?	Executive compensation alignment with company performance
Shareholder rights	Are there dual voting rights? Is there a controlling shareholder? Are minority shareholder rights protected?	Does the company comply with the 'one share, one vote' rule? Are there any take-over defences
Board diversity	Does the board's diversity reflect its operational regions and the diversity within its customer base or workforce?	% of female board directors, industry experience, regional experience

II. Portfolio construction

There are a wide range of fundamental risks which ultimately define the risk of owning a stock. These range from financial considerations such as the strength of a company's balance sheet to operational and ESG considerations such as a company's exposure to a particular regulatory risk or management's level of transparency.

Traditional risk models that rely on normalizing **historic volatility** have consistently failed investors particularly during extreme bouts of volatility. We recognize the limitations of these models and have developed our own proprietary risk framework based on **forward-looking** company fundamentals to help account for these short comings and improve our position sizing and risk optimization efforts.

We have analysed the impact of these risks over time on stock prices to establish a well-designed and consistent framework toward evaluating fundamental risk. We utilize a formal scoring system with weighted risk scores in different categories generated by our team of GSS, which results in a specific risk score for each stock that we own. Quantitative and qualitative factors are used to evaluate risk and in this context ESG analysis is a significant determinant of our assessment of qualitative risk, along with aspects such as management quality, transparency and strategic objectives. These risks are appraised, scored and measured discretely and aggregated into a single risk score based on the following weights.

Fundamental risk score

45%	Leverage	Financial leverage Operating leverage
45%	Quality & Sustainability Assessment	Assessment of industry metrics competitive positioning / Management quality / Transparency / ESG
10%	Country risk	Country of listing Revenue and earning exposure

Source: Schroders, based on the Schroders Global & International Equity Team's assessment of risk.

These scores then become a key factor in determining the position size of stocks in the portfolio. When determining position sizes, a key focus for the portfolio managers is a comprehensive assessment of upside potential, level of conviction, liquidity and the fundamental risk. With 45% of our risk assessment focused on quality and sustainability factors, ESG is a key component of the way we think about portfolio construction.

Integrating customized ESG and sustainability factors for client mandates

It is recognized that some asset owners will have rigid requirements for the exclusion of stocks or industries based on their specific socially responsible investment (SRI) criteria, and this can be accommodated within portfolios without excessive disruption to the investment process. We can apply screening for clients who have specific socially responsible or norms based criteria. In addition we are happy to work with clients to develop appropriate criteria and relevant screens to capture and reflect their SRI or ethical objectives.

A feature of the Schroders ESG-integrated approach is that we have experience of incorporating highly specific investment guidelines without disruption to the team's investment process approach, and these biases or exclusions can be monitored and reported at an individual stock or portfolio level.

As active owners of businesses we recognize that by engaging with companies and encouraging them to adopt policies which promote long term shareholder returns we can improve the outcome of our investments. At Schroders we have a long track record of engaging with companies and encouraging change.

Given the link that has been established between companies with good ESG performance and a low cost of capital, we believe that this type of active ownership will benefit performance over time. Our stewardship activity always focuses on protecting the financial interests of our clients. However, a significant and growing proportion of clients expect us to impress expectations of responsible corporate behaviour on investee companies.

Engagement issues evolve over time and will vary depending on geography. The aim is to continually raise the bar on ESG performance globally. Expectations from stakeholders of companies are rising, and it is incumbent on asset managers to engage with the corporate sector proactively as owners to encourage all companies to improve their ESG performance. We believe also, that this approach is consistent with the ambitions of a new generation of asset owners and beneficiaries, especially in the public sector.

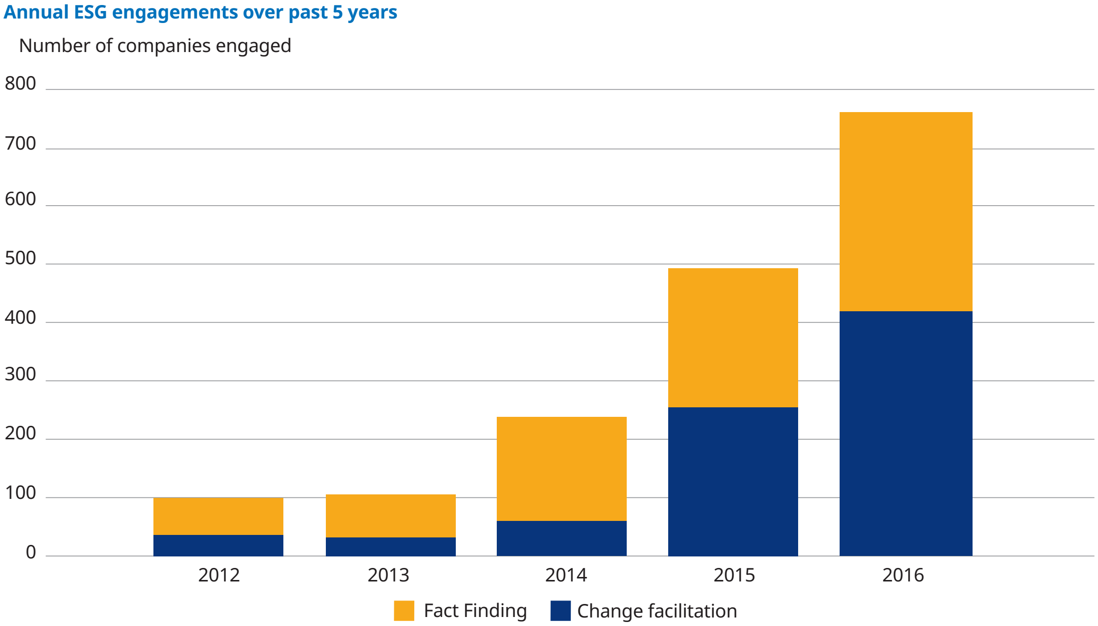
We believe clear and ongoing communication to clients and other stakeholders on our ESG and stewardship activities is important.

Over the past few years we have been working to increase the transparency and usefulness of our reporting. Through the public publication of our annual and quarterly Responsible Investment reports we demonstrate our engagement activity and progress. We also share our research and thought leadership as well as provide insights into innovations and research aimed at maintaining our status as a market leader. We also publicly disclose our global voting activity. More in depth reporting on engagement and voting is supplied to clients.

Policymakers globally have launched Stewardship Codes, setting down clear expectations for Asset Owners and Managers to behave responsibly. Commitments to stewardship are no longer enough; investors must provide evidence through their actions, engagements and voting activities.

The figures below show the variety of issues that we (collectively at Schroders) have raised with companies.

Annual ESG engagements over past 5 years



Source: Schroders Responsible Investment 2016 Annual report

ESG topics engaged in 2016 engagements over past 5 years

Environmental	Social	Governance
Biodiversity	Customers	Accounting practices
Climate change	Data security	Auditors
Environmental policy/strategy	Health & Safety	Board committees
Environmental products & services	Human capital management	Board structures
Environmental supply chain	Human rights	Business integrity
Forests	Labor standards	Corporate strategy
Pollution	Nutrition & obesity	ESG governance & Sustainability strategy
Waste management	Product safety	Governance oversight
Water	Social policy/strategy	Remuneration
	Supply chain management	Shareholder rights
		Succession planning
		Transparency & disclosure
		Voting

One of the most important aspects of engagement is constructive dialogue with those companies aimed at improving performance.

This recognizes that companies rarely fit into 'good' or 'bad' buckets, but should be encouraged to adopt sustainable business practices. We believe engagement priorities should be focused on relative ESG underperformers. Evidence shows that ESG laggards are more likely to negatively impact performance. There is also a performance benefit to be gained from investing in companies who are improving (Source: MSCI ESG report, 2016).

We also utilize engagement to target and measure outcomes, focusing on more than simply investment returns. We use data tools to analyse portfolio holdings in less visible areas such as Health and Safety, supplier codes of conduct, and equal opportunities, and we proactively target improvements over time. Coupled with our in-house database that tracks activity, we have tangible, measurable outcomes.

We also have experience in working institutions' engagement priorities and socially responsible objectives into our overall engagement programme. For example, we have partnered with clients to identify a number of issues on which we will seek improvement through a process of engagement, harnessing the full weight of Schroder holdings.

Unless our clients choose to exercise voting rights themselves, Schroders, on behalf of its clients, maintains share ownership rights and responsibilities and exercises these rights dutifully, through company engagement and proxy voting. We see this as an integral part of our role in managing, protecting and enhancing the value of our clients' investments. In exercising these responsibilities we combine the perspectives of our portfolio managers and ESG analysts to form a rounded view of each company and the issues it faces. It follows that we will concentrate on each company's ability to create sustainable value and may question or challenge companies about ESG issues that we perceive may affect their future value.

We vote all meetings, following internal research, as per our own policy. We employ the widely used Institutional Shareholder Services (ISS) proxy-voting service to deliver our ballots to the company. When voting on an ESG issue (e.g. a shareholder resolution of a social, ethical or environmental nature) we will consider each resolution on a case by case basis, taking into account whether the company has faced the same (or similar) resolution in the past, the quality of the company's performance and transparency on the issue and ultimately whether the resolution is in our clients interests. An effective approach to integration would have recognized and assessed the risks (after share prices fell) and the improvements many banks made to identify better placed companies, rather than turning negative on the sector at its nadir.

Industry challenges

The ESG space has numerous different products and the industry has not been good at defining what clients can expect different approaches to achieve. Products are often lumped under one broad umbrella and evaluated accordingly.

Given the practical issues in building and maintaining a proprietary ESG research capability we understand the attractions of utilising ESG data and ratings provided by third party providers for analysing companies as well as funds. For many asset managers, particularly those lacking scale, it is simply not viable to develop the capabilities required to conduct qualitative ESG research, particularly in a Global context.

While the majority of third party analysis provides a good level of disclosure and may be additive as a starting point for research, it's important to highlight that most of this is backward-looking and based on public disclosures. Crucially, in many instances, this fails to capture a company's current ESG policy or its trend of improvement. While we subscribe to some of data sets, we advocate that they are used with caution and with regard to the limitations and shortcomings that a blunt rating or relatively static narrative provides.

By way of example, emerging markets stocks often exhibit the best practices in the markets they are operate in but score poorly versus their developed market peers. When comparing companies in a global context it is critical to appraise a company on the basis of the market in which it operates and the trajectory of improvement in their practices. Data can also be lagging. For example many banks were ranked very highly on governance prior to the global financial crisis. Most were revised significantly lower in light of events, and continue to rank poorly, despite having dramatically improved their governance structures in recent years. An effective approach to integration would have recognized and assessed the risks (after share prices fell) and the improvements many banks made to identify better placed companies, rather than turning negative on the sector at its nadir.

Measuring the extent to which companies embed sustainability principles cannot be condensed into a single measure. It requires an understanding of the strategy and an assessment of whether that strategy is reflected in the ESG characteristics.

When assessing a company's exposure to climate change, simple measures such as carbon intensity or 'foot-printing' often fail to capture the second derivative. For example, an industrial company which manufactures energy efficient or clean energy products may appear to have higher carbon emissions when only its operational emissions are considered. However, the end use of its products may provide a significant offset to the emission profile of its production. Taking account of a company's products' end-use and changing demand patterns under low carbon scenarios better reflects the real investment risks and opportunities than a simple assessment of operational emissions.

While many financial metrics are standardized across the industry and consistently reported/audited, we still lack global standards for most ESG metrics. Sustainability still lacks a clear definition and translating sustainability value into financial value remains challenging. Transparency and disclosure is not always consistent across companies in the same industry and ESG risks can occur over periods extending well beyond the quarterly financial reporting time frame. It is also challenging to measure the outcome from integrating ESG as it is often viewed as a component of a decision rather than the singular driver of the decision. However, we know these factors can have a meaningful impact on the future value of an investment.
It is therefore more critical to focus on robust fundamental analysis which incorporates the principles of sustainability and incorporates numerous metrics to better understand the durability of earnings, than it is to oversimplify analysis with conventional definitions.

The future of active management

In recent years, flows to passive funds have accelerated amidst fee rationalization and a highly correlated macro-driven environment that has challenged active managers' performance. Passive investing has provided investors with lower fees and a consistent and predictable level of underperformance.

However, in the prevailing low return environment active managers that can consistently deliver attractive outperformance can provide their clients with a very powerful level of alpha to help meet their return objectives.

Amid lower returns and higher correlations among asset classes and the commoditization of factor strategies, investors will be increasingly more focused on delivering idiosyncratic returns and outcomes for their clients rather than simply outperforming a benchmark. Fundamental stock selection and the importance of portfolio construction will invariably play a critical role in delivering idiosyncratic returns.

We believe ESG integration and engagement will be an increasingly important source of alpha for active managers. Historically ESG analysis has been viewed as a means for screening out unwanted companies or ones that fail certain ethical criteria. The backward looking view of ESG as an exclusionary approach does not lend itself to the need for a forward looking assessment required to generate alpha. Data analytics are increasingly becoming more sophisticated and we believe they will eventually provide clear and consistent measures of performance efficacy coming from ESG variables. While there currently remain challenges in measuring these variables in a systematic and objective way, we believe it is simply a matter of time before such metrics are developed that will prove the importance of these variables. As investors are increasingly recognizing ESG integration and engagement as an important source of value, the industry is moving from a mind-set of beating a benchmark towards allocating capital sustainably and holding companies to account.

At Schroders we believe that the ESG performance of companies is inextricably linked to the delivery of long-term shareholder value. As long-term investors, we consider it vital to appraise both financial and non-financial factors when analysing a company and its stock. In our experience, the appraisal of non-financial factors, including ESG, contributes to a better understanding of a company's risk characteristics and return potential. This is a critical component in pursuing strong risk-adjusted returns.

We recognize the importance of our role as active owners and the process of ESG integration and engagement are integral components of managing, protecting and enhancing our clients' investments. By engaging with those companies and encouraging them to adopt policies which promote long-term shareholder returns we believe that we can improve the outcome of our investments.

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