

## ***Responsible Investments in Practice***

*by Jeffrey D. Braemer, CFA*

A desire for Responsible Investments (RI) has gained significant traction in recent years across the investing community, accelerated somewhat by increased adoption of the Principles for Responsible Investment supported by the United Nations.<sup>1</sup> Some asset owners include the recognition of RI as part of their fiduciary duty, or have been mandated to do so by regulatory bodies such as in the U.K. recently (Rust 2019). Numerous institutional investment consultants have increased their focus on evaluating RI across asset classes, whether or not a given investment strategy is explicitly focused on RI.<sup>2</sup> With recognition of the additional dimensions for return and risk this creates, investment managers have incorporated different aspects of RI in their approaches to varying degrees.

RI covers a broad spectrum, which we will differentiate into three areas:

### **Socially Responsible Investing (SRI)**

SRI was an early instance of RI and generally focuses on *avoidance and exclusion*. One of the first widespread SRI movements was in 1977 with the Sullivan Principles, which sought divestment from companies doing business with South Africa in the apartheid era<sup>3</sup>. Simply put, SRI avoids investing in companies that do “bad” things, sell “bad” things, or act in a “bad” manner. Typically those exclusionary screens reflect the beliefs of the asset owners and may vary by group, culture, or geography. For example, a religious group’s pension fund might not invest in casinos if gambling is counter to its doctrine. Similarly, a health organization may prohibit tobacco companies from its foundation’s portfolio. As a matter of fact, TimesSquare has incorporated SRI guidelines requested by our clients in their specific accounts for nearly 20 years.

### **Mission-Driven Investing (MDI)**

MDI, also referred to as Impact Investing, is a more recent development and seeks to *promote and include* certain activities. Here the investment mantra is the mirror image of SRI: invest in companies that do “good” things, sell “good” things, or act in a “good” manner. As with SRI, any inclusionary list of investments reflects the beliefs of the asset owners. MDI is more common among foundations, where the investment criteria are aligned with that organization’s grant-making focus. In 2004 for example, The Russell Family Foundation initiated an MDI program to match its grant support of the environment and people in the Puget Sound area in the state of Washington. That program began with certificates of deposits in small community banks and investments in developing resource-efficient, affordable housing (Russell Family Foundation 2018).

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<sup>1</sup> See <https://www.unpri.org/> for more details on this section

<sup>2</sup> See for example Aon 2019, Cambridge 2016, Mercer, or Russell 2017

<sup>3</sup> See for example <https://www.bu.edu/trustees/boardoftrustees/committees/acsri/principles/>

**Environmental, Social and Governance (ESG)**

ESG seems to have captured the most attention under the RI umbrella. One reason may be that it does not require predetermined screens, either exclusionary (as with SRI) or inclusionary (as with MDI), but instead asks investors to consider a broader context. Taking each letter in turn, each ESG category generally:

- Assesses a company’s stewardship of, and impact on, natural resources (Environmental)
- Considers a company’s relationships with its employees, suppliers, customers, the communities in which it operates, and other stakeholders (Social)
- Evaluates the company’s leadership, compensation, internal controls, and shareholder rights (Governance)

Among proponents of ESG investments there may be overlapping definitions, but as of yet there is no universal agreement or standard. For example, the table below compares ESG categories from the United Nations Principles for Responsible Investment with the CFA Institute’s guide on the subject:

| Environmental      |                                     | Social             |                             | Governance                       |                                    |
|--------------------|-------------------------------------|--------------------|-----------------------------|----------------------------------|------------------------------------|
| UNPRI              | CFA-I                               | UNPRI              | CFA-I                       | UNPRI                            | CFA-I                              |
| Climate Change     | Climate change and carbon emissions | Human Rights       | Human rights                | Bribery and Corruption           | Bribery and corruption             |
| Resource Depletion | Water scarcity & energy efficiency  | Modern Slavery     |                             | Executive Pay                    | Executive compensation             |
| Waste              | Waste management                    | Child Labor        |                             | Board Diversity and Structure    | Board composition                  |
| Pollution          | Air and water pollution             | Working Conditions | Labor standards             | Political Lobbying and Donations | Lobbying & political contributions |
| Deforestation      | Deforestation                       | Employee Relations | Employee engagement         | Tax Strategy                     |                                    |
|                    | Biodiversity                        |                    | Community relations         |                                  | Audit committee structure          |
|                    |                                     |                    | Gender and diversity        |                                  | Whistleblower schemes              |
|                    |                                     |                    | Data protection and privacy |                                  |                                    |
|                    |                                     |                    | Customer satisfaction       |                                  |                                    |

*(Sources: UNPRI and CFA Institute)*

Various data services offer ESG evaluations (e.g., MSCI, ISS, Sustainalytics Morningstar, Bloomberg), each with its own emphasis or approach. Some of the considerations are subjective in nature, and thus resistant to numerical data analysis. Others are more quantitative and while simple screens may capture a “score” for E, S, or G, mitigating factors or the broader context may be missed. In addition, ESG scores often are based on recent or older disclosures from companies, and thus by definition are backward looking.

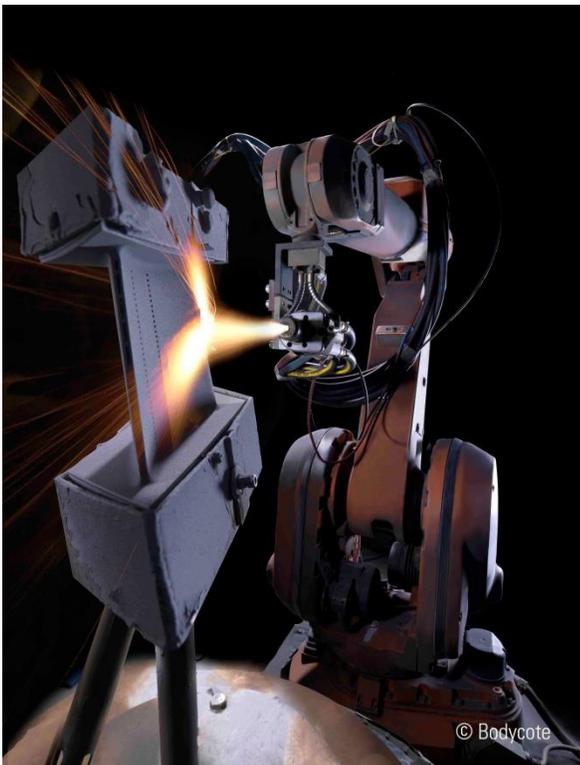
### **TimesSquare’s Approach to ESG**

We believe that Environmental, Social and Governance issues can have a material impact on investment performance. In fact, since TimesSquare’s founding over 20 years ago, our investment process has used corporate governance and management integrity as a key factor in assessing the attractiveness of a business and the investment worthiness of that company’s stock. More recently, we have subjectively incorporated environmental and social criteria into our investment process to enhance our decision making. In addition, we have supplemented our work by subscribing to a third-party data service that provides both company governance profiles as well as evaluations on global norms such as environmental protection, human rights, labor standards and anti-corruption measures.

Though our approach may not match conventional ESG considerations, we believe the examples below convey a sense of our views and philosophy.

### **Bodycote plc**

A U.K. industrial company founded in the early 1900s, Bodycote provides a range of thermal processing services for its clients in a variety of manufacturing areas. By its nature, Bodycote’s heat treatments, metal joining and hot isostatic pressing (high-pressure heat treatments) are all energy intensive—classic heat treatments take place at temperatures above 1,000°C—and do create emissions.



Sources: Bodycote Images (<https://www.bodycote.com/news-and-media/multimedia-resources/images/>).

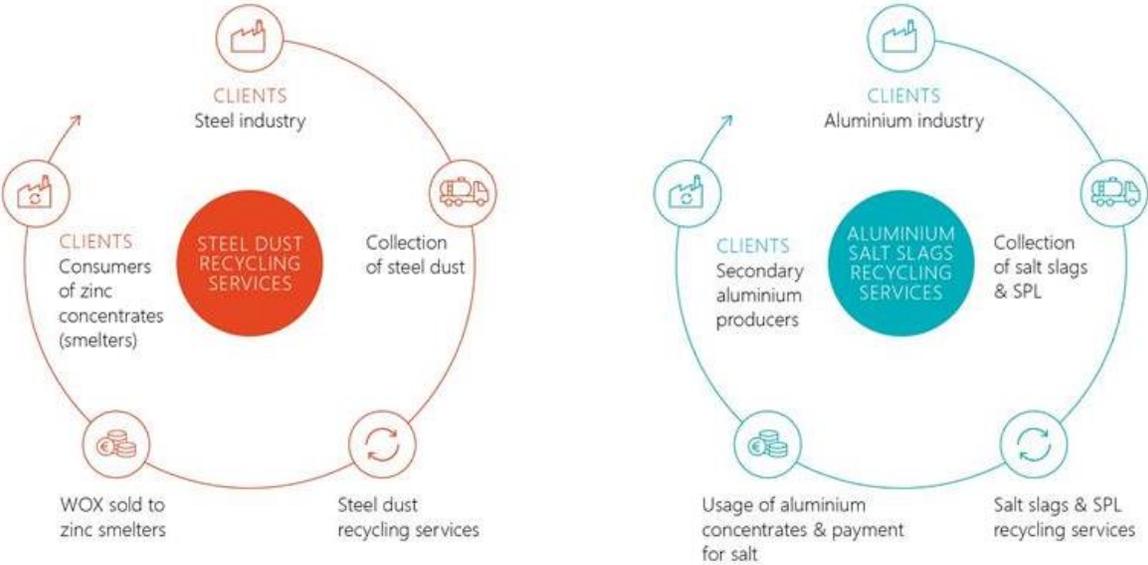
However, Bodycote’s processing significantly extends the lifespan of the metal components it treats, which reduces replacements and waste. For example, these heat treatments allow the ball bearings in a car’s wheels to last for the car’s lifetime, while untreated ball bearings might not survive more than a week of driving.

Additionally, Bodycote strengthens lighter materials, which reduce the vehicle’s weight and thus improve its fuel efficiency (Bodycote 2019). In our evaluation, Bodycote’s local environmental costs are far outweighed by the environmental savings it provides its customers globally.

In the realm of governance, we appreciate that Bodycote has increased the diversity of its board of directors so that three of the seven members are women. While that is less than 50%, it is far greater than the 25% proportion of manufacturing jobs in the U.K. held by women (Powell 2019).

**Befesa SA**

Befesa is another company that we consider having strong ESG aspects despite operating in a traditionally non-environmentally focused area. A German industrial company, Befesa provides hazardous waste recycling for steel and aluminium processors. Historically in most countries, steel and aluminium processors disposed of waste materials in landfills. Because of the adverse environmental impact of that routine, government regulations have limited those options and encouraged the development of sustainable alternatives. Befesa devised such an option for the steel dust created by the electric arc furnaces used for scrap steel, and the salt slags from aluminium recycling. The company handles the collection and processing of the hazardous residues, extracting useful materials that can be reused.



Source: Befesa Sustainability Report 2018

Befesa annually recycles approximately 1.5 million tons of this waste, turning it into nearly 1.2 million tons of new material ready for reuse. Recently the company expanded its predominantly European activities to Asia, with its first plant in China scheduled for operation in late 2020 (Befesa 2020).

**bluebird bio, Inc.**

In our assessment, bluebird has appreciable ESG characteristics. This U.S.-based biotechnology firm develops gene therapies for heritable disorders such as anemias as well as certain cancers. Gene therapies modify a patient’s genetic code to deactivate the malfunctioning gene that causes a specific disease (i.e., stop the body from harming itself), or activate a genetic response to treat that disease (i.e., allow the body to heal itself). Aside from

the benefit that gene therapies are used when no other treatment is available, they are designed to produce long-term or even permanent effects after a single introduction (U.S. Department of Health and Human Services 2020). One concern with these novel treatments has been their high one-time price<sup>4</sup>. When its first treatment was recently approved, bluebird established value-based pricing for Zynteglo so that only 20% of the price was paid at the time of the treatment. The balance would be paid in each of the following four years, provided that Zynteglo continued to be effective by increasing the patient's hemoglobin levels and obviating the need for regular blood transfusions for the remainder of the patient's life. Thus the treatment's cost becomes directly linked to the improved quality of life for the patients (bluebird 2020).

Regarding bluebird's governance, currently there only is one woman on its eight-person board of directors. However, we are encouraged that four of bluebird's twelve senior executives are women (bluebird 2019).

Looking forward, in addition to addressing the high upfront cost to patients for new gene therapies, bluebird has targeted sickle cell disease for its next treatment. This genetic disorder disproportionately affects a population of historically underserved minority patients<sup>5</sup>. Late stage clinical trials are currently underway (bluebird 2020).

### **Trainline plc**

Lastly, a more traditional ESG company is one focused on public transportation: Trainline. Based in the U.K., Trainline operates a mobile platform for train and coach travel across the U.K. and Europe. By providing consumers a single access point for nearly 300 different transit carriers across 45 countries, Trainline's independent service streamlines planning and booking travel (Trainline 2019). That could lead to higher levels of ridership by rail or bus, which could mitigate the greater environmental impacts from air and car travel.

Beyond the E, we have found that Trainline has strong pillars on S and G. At its core, Trainline is a software company and it has partnered with Code First: Girls with the goal of training 20,000 young U.K. women to code software at no cost to the participants. In addition to the financial support, Trainline provides its own specialists to mentor program participants, and hosts courses in its London office (Millman 2018). Recognizing that rail stations often become a shelter of last resort, Trainline also works with the charity Railway Children to protect and find better opportunities for children living on the streets in India, East Africa and the U.K. (Trainline 2020). Regarding Trainline's governance, two of its five board members are women, including the CEO.

### **Conclusion**

Much like an attractive investment, a company with strong ESG attributes could come from any geography or economic sector. The preceding examples provide a window into our approach to recognizing those ESG aspects as we conduct our fundamental bottom-up analysis. As with any other part of TimesSquare's investment process, a company's ESG nature must be reassessed periodically to determine if or where it might be changing. Thus to TimesSquare, ESG becomes another component in our holistic evaluation of a company's return and risk mosaic.

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<sup>4</sup> A recently approved gene therapy from Novartis for pediatric spinal muscular atrophy costs \$2.125 million (Roland 2019)

<sup>5</sup> See for example Haywood et al 2014 or Ware 2013

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