STEWARDSHIP REPORT

EDITION 6

How to measure impact of business decisions P04

China's green electricity revolution P08

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EDITOR'S NOTE

HENRY BOUCHER
DEPUTY CHIEF INVESTMENT OFFICER

Change is a consistent theme in this Stewardship Report including, of course, the threats from climate change. In Glasgow in November 2020, at the biggest international summit the UK has ever held (with over 30,000 delegates), the UK government will host the 26th UN Climate Change Conference of the Parties (COP26). Heads of state, climate experts and campaigners will discuss action to tackle climate change but, as Natasha Landell-Mills argues, without better measurement of the causes of the problem it is hard to get better management. She proposes five new 'climate pledges' that could be made to change the climate impacts of businesses and consumers.

Alex Cobbold and Ben McEwen explore the unprecedented levels of investment required in new sources of renewable energy and find the bright spots as technology and cost deflation are dramatically changing the outlook for fossil fuel energy compared with renewable generation. With electricity demand in China likely to grow by 50% by 2050, the choices and policies of the Chinese government warrant particularly close attention.

A different kind of power paradox is explored by Subitha Subramaniam as she considers how politicians are being empowered 'to move fast and break things' and disrupt the status quo to address major challenges like inequality and climate change. The vanishing centre ground of politics is unleashing new heights of fiscal spending, but in the face of longer-term challenges, is this enough to provide anything more than a temporary boost to growth?

And what should asset managers do about inequality? Therese Kieve argues that BRICS (Brazil, Russia, India, China and South Africa) is more an acronym for growing inequality than emerging economic growth and that it is crucial to understand how employees all along the supply chain are treated. Fund managers should properly hold company executives to account by voting against management in a range of circumstances (including on egregious pay).

The Chairman of our Climate Active Advisory Panel, David Pitt Watson, also makes a good case for shareholder democracy and Richard Maitland offers a list of the characteristics of 'careful' and 'care-less' asset managers.

Diet change is another topical change we explore: Jeneiv Shah bites into mock meats as he assesses the implications of rising veganism and the need to transition to a more sustainable global food system. The use of land is a crucial consideration for climate change and biodiversity and we also imagine how change in land use on a sufficiently large scale could be engineered: 'Eden Bonds' is one suggestion to fund a wholesale shift in land ownership and large scale 'rewilding'.

Bond holdings are normally listed at the top of investment valuations, but on this occasion, they are left until last, but not least: bond fund manager Tony Carter unveils some of the ethical considerations in managing a responsible bond fund.

We hope you enjoy this report and, as ever, we would welcome any comments or suggestions for improvement.

"Life is like riding a bicycle. To keep your balance, you must keep moving"

Albert Einstein

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HOW TO MEASURE THE IMPACT OF BUSINESS DECISIONS ON CLIMATE CHANGE

PUBLISHED IN THE FINANCIAL TIMES

What gets measured gets managed. The climate impact of business and consumer decisions is not being fully measured and thus not being properly managed. Decisions on where to invest and what goods and services to buy are ignoring the consequences for our planet. This market failure could prove to be our undoing, unless it is urgently fixed.

A global carbon tax would be by far the neatest policy solution: put simply it would force everyone to internalise the climate externality. The IMF estimates that to deliver the 2015 Paris climate agreement's goal of keeping the global temperature rise well below 2°C, we need a tax worth about $75 a tonne of carbon. But a charge of that magnitude is politically toxic for many and, despite considerable efforts to clinch a global deal, there is little sign of a governmental breakthrough.

FIVE MARKET PARTICIPANTS WHO COULD HELP CREATE CHANGE

While we wait, there are other levers we should pull to help transform behaviour. To put us on track toward net zero carbon emissions by 2050, we need five groups of market participants to step up and align their work with the Paris agreement goals. They have the power to reshape financial incentives in this area.

First, we need to incorporate climate effects into the rules that govern how companies calculate their profit and capital. In more than 140 countries, the International Accounting Standards Board sets these standards. Until recently, companies could report accounting numbers with little regard for either the climate consequences of their activities or the probable impact of efforts to reduce carbon emissions.

NATASHA LANDELL-MILLS
HEAD OF STEWARDSHIP

EDWARD MASON OF THE CHURCH COMMISSIONERS OF ENGLAND ALSO CONTRIBUTED TO THIS ARTICLE

This matters because financial statements underpin capital allocation decisions. If you ignore decarbonisation promises, a coal-fired power station looks like a good investment choice because it appears to offer high returns. Factor in policies to phase out coal power, and the station looks like a much riskier, less attractive choice. In November, the IASB reminded companies that they should be including anticipated material climate-related impacts in their accounts. We need to go a step further. Companies need to make visible what their profit and capital would be, given a sustainable climate. Paris-aligned accounting would be catalytic.

> "We need five groups of market participants to step up and align their work with the Paris agreement goals."

AUDITORS MUST CALL OUT COMPANIES

Second, auditors — particularly the Big Four firms PwC, KPMG, EY and Deloitte — need to call out companies that fail to acknowledge that their financial statements would be hit by an accelerated transition to net zero carbon. This would enable investors to evaluate climate risks, and shift capital today, reducing the danger of a disorderly transition in coming years.

Third, shareholders need to vote against directors and auditors who fail to act to prevent climate harm. Proxy agencies Institutional Shareholder Services and Glass Lewis, which advise investors on how to vote on an estimated 97 per cent of company votes, have a responsibility to lead here. Their voting recommendations should not support directors who are pursuing strategies that exacerbate climate change.

Fourth, the largest asset managers have a critical role to play. BlackRock, Vanguard and State Street should commit to supporting only those directors who align their corporate strategies with net zero carbon emissions by 2050. Fifth, the credit rating agencies, S&P, Moody's and Fitch, have the power to help determine companies' borrowing costs. If they capture climate risks in their ratings, fossil fuel-based activities would become more expensive, while cleaner solutions would get cheaper. The rating agencies should pledge to do that.

Together, these five groups could do a lot to align business incentives with the goals of the Paris agreement. Who knows, they might even generate much-needed momentum toward a political settlement as well.

ASSET MANAGERS MUST USE THEIR VOTES TO TACKLE CLIMATE CHANGE

PUBLISHED IN THE FINANCIAL TIMES

NATASHA LANDELL-MILLS
HEAD OF STEWARDSHIP

As we emerge from the 2019 voting season for listed companies — the time of year when shareholders elect company leaders — asset managers have once again ducked their responsibility to help address the climate crisis. At ExxonMobil, Chevron, BP, Shell and Total, directors were appointed with an average 97 per cent support from shareholders.

ASSET MANAGERS HAVE THE POWER TO CREATE CHANGE

Yet these companies are collectively ploughing billions of dollars into future fossil fuel extraction, which threatens the climate and makes increasingly questionable investment returns. Business-as-usual is unsustainable and this must mean change to the corporate leadership promoting it. Asset managers, tasked with overseeing companies and voting for boards of directors on behalf of millions of savers, have the power to achieve this.

Companies continuing to deploy capital in a way that perpetuates the fossil fuel economy is harmful to shareholders for two reasons. First, they lock us on to a pathway that scientists tell us threatens planetary stability. According to research by Carbon Tracker, for example, the carbon emissions generated by roughly 60-80 per cent of expected capital spending on new oil projects for the next decade will exceed what the world can cope with if it is to avoid climate chaos. Auto manufacturers, construction companies and heavy industry likewise often invest in new infrastructure and equipment without considering its climate impact. Second, where companies fail to take into account the regulatory measures that governments will inevitably take to combat climate change, their profits are likely to be hit, harming shareholders.

> "The question is why so many asset managers are failing to vote for change."

BOARDS MUST COMMIT TO ALIGN WITH THE PARIS AGREEMENT

Rapid advances in clean technology only bring forward this headwind. It should be self-evident that businesses linked to the fossil fuel economy need to change. Boards need to commit to align with the 2015 Paris agreement's goal of keeping global warming well below 2°C and set out a credible strategy for getting there, which protects shareholder capital. This may mean shifting capital into low carbon alternatives or shrinking and returning cash to investors. According to think-tank Aurora, the $500bn or so a year being invested in oil and gas is roughly what is needed for wind and solar every year to meet the Paris goals. To drive decarbonisation, asset managers must move beyond supportive statements and use their votes. If a company's strategy is flawed, shareholders can change the leadership. The question is why so many asset managers are failing to vote for change. One problem is a lack of accountability: few savers have any idea how their shares are being voted. Often, they do not even know which companies they hold shares in.

Another obstacle is short-termism. Too many fund managers believe climate change is unlikely to affect them over the next quarter or financial year where they are focused. Some believe their fiduciary duty prevents them from acting. The opposite is more likely to be true. Where asset managers fail to reflect material risks in their investment process, it is hard to see how they are putting their clients' interests first. We've seen the story of failed accountability before. It resulted in the financial crisis. Directors at banks were routinely reappointed with more than 95 per cent support despite overseeing strategies that led to a dangerous build-up of risk. The consequences this time around will probably be far graver than in 2008.

INVESTORS CAN GET INVOLVED WITH CLIMATEACTION 100+

There is some good news. Directors at Maersk, the global shipping company, last year committed to aligning their strategy with the Paris goals. Amazon has just announced they will get to net zero carbon emissions by 2040. On the investor side, the ClimateAction 100+ initiative has brought together institutions managing assets worth more than $35tn to call for better climate governance. But time is running out. It is no longer enough to applaud progress that only gets us half way.

A DECADE OF DECARBONISING POWER

The future of energy will be shaped by how we respond to its central paradox. How can we generate more energy with fewer emissions?

The Paris Climate Agreement signalled a commitment to limit the increase in global average temperature to well below 2°C. Under all energy-system forecasts that keep temperatures below this level, the electricity-generation system must be entirely decarbonised, meaning its emissions should be close to zero.

Yet electricity is only as green as its source. In 2019, the global electricity sector represented approximately a quarter of all global emissions.

> "Existing utility companies face several challenges in pivoting their generation mix away from fossil fuels."

Fossil fuels have commanded a consistent 60-70% share of the global power-generation mix since the 1970s. Reducing emissions will require a material restructuring of the historically slow-moving global power-generation system.

Energy-efficiency objectives have not succeeded in stemming the global demand for electricity, which is forecast to grow by 62% between 2019 and 2050. This increased demand is a function of three principal factors: global population growth, economic output increases (particularly in non-OECD countries such as India and across Africa), and the impetus to electrify processes historically based on fossil-fuel use. We are entering a decade of unprecedented disruption in electricity generation and consumption.

The good news is that the electricity-generation cost landscape has already changed dramatically over the last five years. The cheapest way to generate electricity is no longer from coal and gas but via onshore wind and solar power. The primary reason for this dramatic shift has been falling equipment costs. Solar module costs are almost 70% lower than five years ago, while wind turbines are now 40% cheaper than five years ago. Not only are wind turbines cheaper – they can also extract around 20% more energy from the same wind field.

Cost deflation and technical advancements are likely to continue. Indeed, according to BNEF estimates, the levelised cost of electricity (an industry benchmark which include life cycle capital costs) for onshore wind is forecast to fall a further 50% by 2050, while utility solar costs are forecast to come down by 63% across the same time frame.

As the world strives to limit temperature increases, more electricity will have to be generated through renewables. Indeed the International Energy Agency's Sustainable Development Scenario points towards renewable technologies representing two-thirds of electricity generation globally by 2040.

THE ROLE OF INVESTMENT IN A DECARBONISED ENERGY SYSTEM

None of this comes without a significant investment into renewables. Projections vary depending on the extent of policy support but range from around $500 billion per annum to $700bn per annum, or some $10 trillion to $15 trillion on a cumulative basis between 2019 and 2040. Some projections are even greater.

What does the renewable takeover mean for fossil fuels? Coal currently represents around 35% of global electricity generation but this number will decline to below 5% by 2050 and zero thereafter. Indeed, the global pipeline of new coal capacity is already shrinking, while older plants are now being pushed out by cheaper alternatives. Provisional estimates suggest that 2019 electricity production from coal is set to fall by 3% year on year.

The role of oil and gas is set to fade. Spanish energy company Repsol recently announced that it will be transitioning to a net-zero-emissions company by 2050; it is the first oil and gas company in the world to assume this goal. But this decade is likely to see many more incumbent fossil fuel producers respond to the risks that rising carbon emissions present to society.

BEN MCEWEN
CLIMATE CHANGE ANALYST

ALEX COBBOLD
HEAD OF EQUITY RESEARCH

"The good news is that the electricity-generation cost landscape has already changed dramatically over the last five years"

Given the requirement for unprecedented levels of investment in renewables, it's perhaps surprising to find that the universe of investment opportunities, whilst expanding, is still relatively small at around $1 trillion – less than a 25th of the size of the fossil fuel market it is disrupting. Why is this so?

It's already been noted that renewable technologies have experienced significant price deflation as technology and materials have evolved. However, the key factor has been economies of scale. Ten years ago, subsidies and tax breaks provided a cash-flow safety net for companies offering renewable solutions to an embryonic market, but these have now largely been withdrawn as adoption accelerates and volumes rise. Renewable company returns are now determined by market forces, which is at the heart of why the sector opportunities are still relatively limited.

Existing utility companies face several challenges in pivoting their generation mix away from fossil fuels. The levelised cost of electricity generation for new investment may be lower for renewables, but they remain higher than those earned from partly or fully depreciated fossil-fuel assets.

Compounding this is the fact that for the past decade, electricity demand in most developed markets has been benign. Utilities companies have therefore had little impetus to invest in new capacity. In the absence of subsidies, how to bridge the returns gap and navigate the transition towards renewables is a dilemma faced by many utility companies. Investors have been crowding into the few that have successfully led the transition and have been content to watch from the rest of the packs deliberations from the side lines.

Management strategy has made other segments of the renewable supply chain unattractive for investors. Three wind turbine companies consolidating around 70% of a global market expanding at over 12% a year hints at an investment nirvana – one of pricing power and multi-decade, double-digit volume growth. But in reality the scrum for market share and technical supremacy has effectively capped returns and set in motion a structural price deflation spiral. It's a similar story in high-voltage electrical cables and perhaps at its worst in solar where there are very limited technical or material barriers to entry. The rush to the bottom has decimated returns and there is scant evidence that this won't continue through the course of this decade as well.

HERE CAN OPPORTUNITIES BE FOUND?

However, there are some bright spots. Carbon-offset prices have risen to the point that current coal-power generation in the EU is now uneconomic. Coupled with inter-governmental leapfrogging to decarbonise economies it suggests utilities will pivot sooner rather than later, forcing investors off the side lines. It also requires regulators to improve the returns that can be earned from monopoly-grid operations to ready the infrastructure for new and distributed capacity as well as rising loads. If costs can be contained and projects executed on time, grid infrastructure is likely to become an increasingly attractive global investment opportunity. We have identified several opportunities in electrical networks across European and North America where the trend of low-carbon power provides a decade or more of increasing returns to investors, almost irrespective of the prevailing economic environment.

Wind farm operators remain in the sweet spot of strong order books and deflationary costs. Although it is a renewable technology which is becoming increasingly crowded, it's a theme we identified early and the established market leaders, especially in offshore wind, are still able to earn superior returns to the newcomers due to their economies of scale and experience in project execution. Most participants in off- and onshore wind have also succeeded in replacing the largely withdrawn state power price subsidies with Purchasing Power Agreements (PPA) which lock in returns, providing investors with an attractive low-risk annuity income flow.

As we head into another decade of compressing global yields, these characteristics are becoming increasingly rare yet are qualities highly sought by portfolio managers to balance risk. It is likely valuations will remain well supported into the future. However, the ultimate beneficiary of a decarbonised power market is society as a whole, giving the consumer the prospect of enjoying both structurally lower power prices whilst securing tomorrow.

CHINA'S GREEN ELECTRICITY REVOLUTION

China's going need a lot more electricity. The good news is that this boosts the renewables sector and other potentially fast growing opportunities. The bad news is that Chinese companies remain hard to invest in, chiefly because they fail to achieve levels of governance we would find acceptable.

Over next three decades, demand for electricity in the People's Republic of China is forecast to grow by 55% 2017 to 2050.

This rapid increase is driven by the nation's transition towards higher per capita consumption, to match levels in more developed economies. And this trend will be amplified by the requirement to manage climate change.

> "China has long relied on domestic coal resources to meet electricity consumption"

As a signatory of The Paris Climate Accord of 2015, China is required to reduce greenhouse gas materially over forthcoming decades, before bringing emissions to a net zero position.

One way to achieve these goals is to use electrified solutions. For example, transport systems which currently use fossil fuels could run electricity, or hydrogen. And industrial processes could run on electricity rather than gas. Both of these could help the country to achieve its zero emission targets.

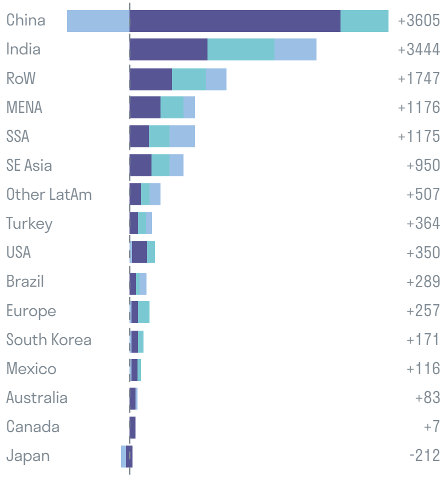
BREAK WITH THE PAST

Future high demand comes after decades of increased power use. The nation's growth in gross domestic product over the past four decades has resulted in a significant increase in electricity demand.

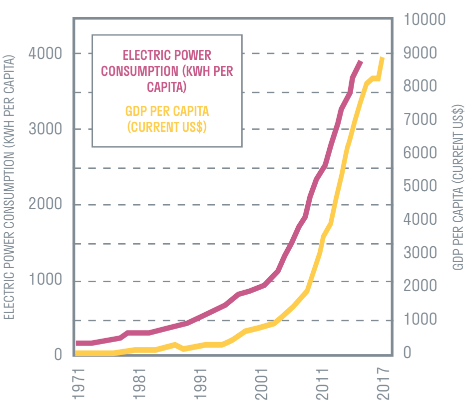
As heavy industry and domestic consumption grew, electricity consumption rose from 1,355 TWh in 2000 to 6,495 TWhin 2017. This has made China the world's largest consumer (25.4%), surpassing the United States (16.8%) and the European Union (15%).

In the future, we anticipate demand for electricity will be decoupled from economic growth. This will primarily be the consequence of a continued shift from industrial to service economies and a marked increase in energy efficiency. This trend is already in evidence in developed nations.

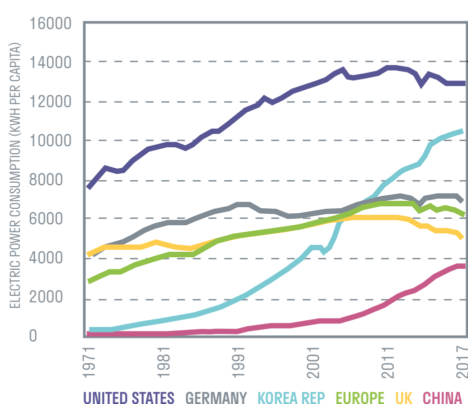
FORECAST CHANGE IN GROSS ELECTRICITY DEMAND, 2017-2050



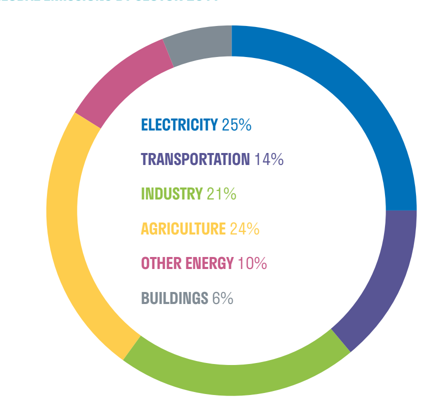
HAND IN HAND: CHINA'S ELECTRIC POWER CONSUMPTION PER CAPITA & GDP PER CAPITA



BUT ELECTRIC CONSUMPTION HAS PLATEAUED IN EUROPE AND THE US



GLOBAL EMISSIONS BY SECTOR 2017



BEN MCEWEN
CLIMATE CHANGE ANALYST

TOWARDS RENEWABLES

China has long relied on domestic coal resources to meet electricity consumption. It is the dominant fuel in the country's power system, accounting for 62% of capacity and 71% of generation in 2017 .

In recent years, however, Chinese policies have increasingly focused on the environmental and economic costs of coal. This is due to negative health effects from localised pollution – because burning coal has created 1.16 million tonnes of sulphur dioxide (S02) and 1.11 of nitrogen oxides (NOx) emissions.

The impact of China's power generation on global C02 contributions is immense. The sector is the country's largest source of emissions, accounting for 40% of total emissions, and for 11.1% of the world's total C02 contributions.

To reduce both localised pollution and the nation's contribution to global greenhouse gas levels, there has been a structural transformation of the power system.

The Chinese government has created incentives to support the development of clean energy sources, and coal's share of the power mix has fallen from 81% in 2007 to 65.5% in 2017. These enticements have played an important role in the green transition. As the cost of renewable energy generation has fallen, the capacity of solar, wind and hydro capacities have grown.

China has developed the largest installed capacity of renewable energy globally. This is forecast to grow further with green technologies accounting for an ever-increasing share of the power generation.

"Chinese policies have increasingly focused on the environmental and economic costs of coal"

THEMATICALLY POSITIVE, BUT THIS IS CHINA

We have a high degree of confidence that:

- Chinese electricity consumption will rise;
- a growing proportion of energy generation will be from green energy sources ; and
- the digitalisation of the electricity system will increase

"Over next three decades, demand for electricity in the People's Republic of China is forecast to grow by 55% 2017 to 2050"

In other words, there are strong multi-decade thematic drivers which investors should be able to harness.

But taking a closer look at the structure of the electricity system and it's less obvious how international investors can benefit from this trend.

That's because the power system is principally controlled by the State and State Owned Enterprises (SOEs – see box).

China's government started the first-round reform of the power industry in 2002, when it dismantled the monopoly Sate Power Corporation. There was a second-round of reforms in 2015, but despite these attempts to shake up the industry, it remains dominated by SOEs.

SOES AND THEIR ROLE

China has a dual track corporate sector. The centrally controlled State Owned Enterprises (SOEs) played an important role in the development of modern China and today's leadership sees them as an essential component of Communist Party control.

SOEs typically earn a lowly 2% return on assets, are highly indebted, frequently loss making, low growth businesses, badly in need of reform. They have not been good investments.

OUTLOOK

The continued role of the State and SOEs in the electricity sector is likely to endure as energy generation is viewed as a sovereign industry and closely aligned to the nation's security.

As the global economy becomes more electrified and networked, transmission and distribution networks "are key elements of a state's security and defence. They constitute a vital infrastructure for the economy as well as for the communications of a country."

Given this strategic import, we do not anticipate any significant loosening of control of the domestic energy sector.

In addition, there are serious limitations on the returns which can be generated from a sector with continued state involvement. That materially reduces our confidence in the returns available from investing in this electrification transition.

Outside China, we continue to invest in electrification themes through holding companies such as Orsted, Enel, NextEra and Schneider. We will continue to monitor China for segments of the market in which we can identify strong thematic drivers and companies well positioned to capitalise on those trends.

WHAT HAPPENS WHEN POLITICIANS 'MOVE FAST AND BREAK THINGS'?

SUBITHA SUBRAMANIAM
CHIEF ECONOMIST

In 2013, Mark Zuckerberg, the CEO of Facebook, popularised the mantra "move fast and break things" to describe how technology innovators bring about change. He argued that companies must move at breakneck speed to disrupt the status quo. Accuracy and accountability follow later. In short order, other technology companies followed Facebook's lead and disruptive businesses have since flourished.

Recently, politicians have also started to embrace this disruptive philosophy. Newly formed parties – from the Five Star movement in Italy to Alternative fur Deutschland (AfD) in Germany – have ostensibly challenged accepted political beliefs and enjoyed stunning success at the ballot box. Incumbents, facing a 'stand-still and perish' threat, have followed suit. As politicians of all hues cast aside accepted truths, the centre ground of politics is rapidly vanishing. Politics, everywhere, is lurching rightwards and leftwards.

The new breed of disruptive politicians has little interest in anchoring policies on the opinions of experts. Instead, there is a growing disregard for institutions and their knowledge banks. In such an environment, policies can become unmoored from the liberal, market-driven principles on which much of post-war prosperity has been based.

WHY ARE POLITICIANS JETTISONING CONVENTIONAL THINKING?

For much of the past 70 years, the global economy experienced strong growth as favourable demographics amplified strong productivity trends. With many of the world's citizens enjoying decades of sustained increases in living standards, a strong global consensus in support of unfettered open markets as the best way to cement progress in rich and poor countries emerged.

The financial crisis of 2008 and its economic scars, however, have profoundly shaken this belief; not only was the global recession deep, but the recovery since has been disappointing at every turn. Furthermore, demographic trends are now on the wane and productivity growth is disappointing across the board. There is little confidence that the global economy will once again attain pre-crisis levels of growth.

Waning growth is exposing the dark underbelly of capitalism: increasing income and wealth inequality. Chart 1 plots real income growth for the period from 1980 to 2016 for different income groups. This chart is called the elephant curve of global inequality; the trunk of the elephant captures the strong income growth of the top 1%. It also shows a 'squeezed middle' – the global middle class that has experienced very modest increases in real incomes during the past 30 years. This is a demographic segment that is disproportionately represented by the bottom 90% of the population in the US and Western Europe. The trend in global wealth is no different. Chart 2 shows a global middle class that has experienced relatively modest increases in real wealth relative to the top 1%. This stagnation in real income and wealth is feeding a growing discontent with conventional policies and has opened up the political status quo for disruption.

"The new breed of disruptive politicians are targeting the vast swathes of the population that have fared relatively poorly."

THE NEXT BIG THING IN POLICY-MAKING

Across the world, politicians are pitching plans to restore distributional equity. Policies like Medicare for All, People's Quantitative Easing, Modern Monetary Theory (MMT), and Universal Basic Income all seek to address the democratic need for greater income and wealth equality. That the slowdown in growth is taking place at the same time as risks from climate change are also emerging is also forcing politicians to confront the intergenerational inequity associated with a warming planet. Policies like the Green New Deal, championed by the Democrats in the US, are attempts to steer the economy towards a more sustainable path in response to the growing demand from younger generations.

CHART 1 THE SQUEEZED MIDDLE IS DISPROPORTIONATELY AFFECTED BY INCOME INEQUALITY
The elephant curve of global inequality and growth, 1980-2016

Source: WID.world (2017). See wir2018.wid.world for more details.

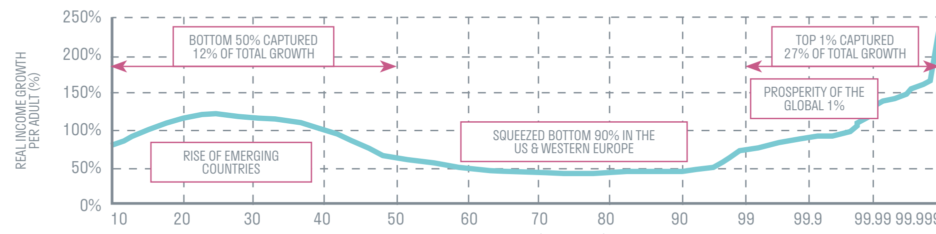
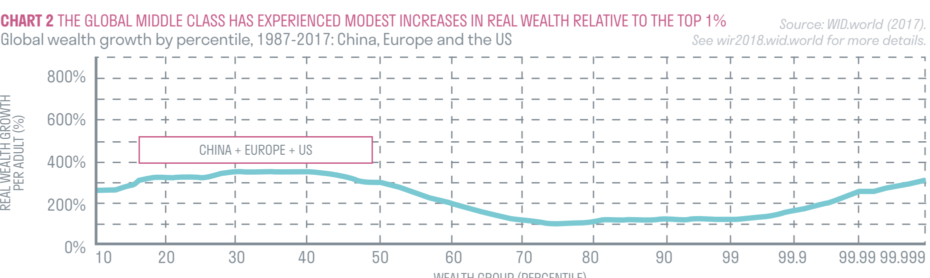


CHART 2 THE GLOBAL MIDDLE CLASS HAS EXPERIENCED MODEST INCREASES IN REAL WEALTH RELATIVE TO THE TOP 1%
Global wealth growth by percentile, 1987-2017: China, Europe and the US

Source: WID.world (2017). See wir2018.wid.world for more details.



A FISCAL EMBRACE ...

The new breed of disruptive politicians are targeting the vast swathes of the population that have fared relatively poorly. They are calling for a more muscular fiscal agenda that includes increases in spending on health, infrastructure, defence, climate and education. In the US and UK, calls for greater spending are being accompanied by proposals for lower taxes. This new fiscal agenda will lead to a deterioration in public finances: fiscal multipliers – the growth impulse from additional government spending – are typically low when economies have limited spare capacity. This is because when labour markets are tight, increased government spending will likely crowd out private enterprise. At this stage of the economic cycle, increased fiscal spending is unlikely to usher in a growth tide that lifts all boats.

While increased spending on infrastructure and education can deepen an economy's capital stock and raise productivity, sustained increases in productivity (known as total factor productivity) need much more. They require the right ecosystem for driving and rewarding innovation – aspects typically outside the sphere of influence of government budgets. In his 1994 paper, 'The myth of Asia's Miracle', Paul Krugman famously criticised the East Asian growth model of the 1990s – driven mostly by capital deepening – as unsustainable. The ensuing financial crisis in 1997 serves as a cautionary tale. Governments also have a poor record in effectively deploying their budgets. As a result, there are strong grounds to believe that the coming fiscal expansion will likely raise debt and deficit levels while having a very modest impact on productivity and growth.

...BRINGS THE RISK OF FISCAL DOMINANCE

Since the financial crisis, monetary policy has been the dominant policy lever. Central banks have taken aggressive and unorthodox measures to reflate the economy. Now, more than ten years later, there is a growing consensus that not only is the toolkit much diminished but also additional monetary policy easing will likely have limited impact on the economy. Instead, there is a gathering consensus that fiscal policy will need to start playing a much more active role. Accompanying this shift is a rethink about debt thresholds – the appropriate level of debt an economy can sustain without compromising growth and inflation. There is a tacit acceptance that debt-to-GDP levels can approach 100% without damaging the economy.

Even though higher debt thresholds create fiscal space, a more muscular fiscal agenda will need monetary policy to remain accommodative – to contain the interest burden associated with rising debt levels. Low interest rates along with quantitative easing will be essential to anchor current and future interest rates. Over time, there is a risk of fiscal dominance – where monetary policy not only contains the government's interest burden but also explicitly starts to fund inefficient government spending. Policies such as the previously mentioned MMT and People's Quantitative Easing, and purported plans to convert existing government debt into Zero Coupon Perpetual bonds (essentially turning them into cash) are harbingers of an impending collaboration between monetary and fiscal policy.

IT'S TIME TO DISRUPT THE STATUS QUO

In summary, politicians are now being empowered to disrupt the status quo. In the coming years, we expect a steady expansion of fiscal policy aimed at addressing the inequities built-up in society. With it, public debt and deficit levels are set to rise. Even so, monetary policy will remain accommodative and the era of low interest rates will remain with us. Unorthodox monetary policies will be essential to enable the coming fiscal expansion. These policies might provide a temporary boost to growth, but ultimately longer-term challenges – such as those around demographics and productivity - are likely to prevail. The world is slowing and a heterodox marriage of monetary and fiscal policy is unlikely to become a long-term salve. Furthermore, there is a very material risk that this becomes an unequal marriage – with a subservient monetary policy leading to a deterioration in confidence and inflation expectations lower growth further still. Over the long term, any economic resurgence will very much depend upon the next wave of disruptive innovation from technological companies. Politicians will do well to heed the advice of another technology disrupter – Google – and 'Do No Evil'.

ARE ASSET MANAGERS DOING ENOUGH TO TACKLE INEQUALITY?

Until recently, most CEOs subscribed to the philosophy that a corporation exists principally to serve its shareholders. That changed in August 2019, when the Business Roundtable, a US business group, issued a new statement declaring that a company exists 'for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders'.

THERESE KIEVE
STEWARDSHIP ANALYST

This rejection of shareholder primacy has triggered heated debate. Jamie Dimon, Chairman and CEO of JPMorgan Chase & Co and Chairman of the Business Roundtable, announced, "The American dream is alive, but fraying".

While the statement is certainly a positive step forward, the Roundtable's commitment is far from ground-breaking. A similar requirement has been enshrined in UK law since the Companies Act of 2006. Directors must promote the success of the company, while having regard to its long-term impacts, including on employees, customers, suppliers, the environment, and local communities.

Perhaps more worryingly, the Business Roundtable statement may be a red herring. While we agree that we require a more balanced set of objectives for companies (which underpins our stewardship approach to investing), the greater problem with the market today is not shareholder primacy, but a lack of accountability to the underlying shareholders, ordinary savers and pensioners.

WHY SHAREHOLDER ACCOUNTABILITY MATTERS

We live in a world of vast economic inequality. According to the World Inequality Report, since 1980, income inequality has increased rapidly, especially in North America, China, India and Russia. Net private wealth for the few has risen, yet net public wealth has declined in all regions, severely hampering governmental ability to mitigate income inequality.

Shareholders have a variety of tools at their disposal to address this inequality. Yet, too often, those delegated the responsibility to exercise these rights on the underlying shareholders' behalf – asset managers – don't use these tools effectively.

A RIGHT BUT ALSO A DUTY

Ownership of a stock confers important rights. Among them are the right to select the company's leadership, approve major transactions, choose the auditor and vote on senior executives' pay. These decisions can have a major impact not only on a company's ability to deliver long-term value, but also on its ability to help mitigate inequality and unfairness.

However, ownership of a stock also bestows the responsibility to exercise these rights with due care and consideration. Against a backdrop of rising anger over inequality, one might think executive pay packages would be regularly thrown out. In fact, the results suggest a different story. Take JPMorgan's CEO Jamie Dimon for example. His pay in 2018 was $31 million, and shareholders approved this, with 72% voting in favour. Since becoming CEO in 2005, he has taken home an astonishing $330 million.

CEO compensation is now so high that as of 2018, the CEO-to-typical worker ratio in the US is 278-to-1, up from 20-to-1 in 1965 and 58-to-1 in 1989.

Between 1978 and 2018, CEO compensation increased by 1,007.5%, far outpacing market growth; in the same period, the S&P 500 index grew by 706.7% and the average US worker's salary grew by a paltry 11.9%[1].

WHY IS THIS HAPPENING?

The majority of votes are undertaken by asset managers, on behalf of their clients, yet far too often asset managers just vote with management or in some cases do not vote at all. In 2018/19, according to Proxy Insight data, the overall percentage of votes against remuneration proposals was a mere 6% for FTSE 100 companies and 9% for S&P 500 companies.

Given popular consciousness around income inequality, the average investor might be surprised to find out that the asset manager they trust to look after their money has voted in support of questionable pay packages. When asset managers vote in favour of remuneration packages that reinforce economic inequality, are they keeping the benefits of customers, employees, suppliers and communities in mind? And, ultimately, is this in the interests of the underlying shareholder, given the critical importance of economic stability for long-term growth and earnings?

WHAT CAN ASSET MANAGERS DO TO COMBAT INEQUALITY?

At Sarasin & Partners, we look closely at executive pay. We have long felt it important to take a stand on the level of executive pay alongside the structure of pay, which ensures alignment with long-term value creation. We also look to see clear disclosures around short-term bonuses, targets that are a sufficient stretch, and a fair approach to pension contributions, rather than one that gives significantly preferential treatment to senior executives.

In the 2018 proxy season alone, we voted against 48% of raised remuneration proposals, including at JP Morgan. We recognise the value that Jamie Dimon has brought to JP Morgan and continue to hold the shares. Nonetheless, we also believe that it is important for CEOs to understand their impact on society, especially when value added doesn't justify excessive levels of pay.

> “Voting against excessive remuneration is one way in which shareholders can help ”

Where we have had cause to vote against a company's remuneration report over two or more consecutive years without seeing improvements, we typically also vote against the re-election of the Remuneration Committee Chair, unless we feel there are extenuating circumstances. In our view, a key part of holding the board to account is holding individual directors accountable for their area of responsibility.

ACTIVE OWNERSHIP MEANS ACTIVE ENGAGEMENT

Voting against excessive remuneration is one way in which shareholders can help ensure executive pay does not exacerbate inequalities. Active engagement with companies to ensure their business practices consider societal impacts is another.

Take the clothing industry, which typically sources from very poor countries. When thinking about supply chains, it is important to understand how employees all along the chain are treated. We believe that our engagement with AB Foods, the owner of Primark, serves as an illustration of how asset managers can work with companies to encourage change.

We gained assurances that Primark is training procurement staff and suppliers to look out for and identify potential instances of forced labour within the supply chain. We were also pleased to see that Primark was an early signatory to the Bangladesh Accord, established after the Rana Plaza factory in Bangladesh collapsed in 2013. We continue to work with the company to understand progress, particularly in light of the potential closure of this Accord in the near future.

Another area of focus for us has been issues relating to the opioid crisis. Last year we engaged with AmerisourceBergen, a large US pharmaceutical distribution company, on their role in the opioid crisis. Despite gaining some comfort that they were taking steps to allay any concerns over their behaviour, we ultimately decided to sell our holdings in the company due to ongoing uncertainty.

“The impact of company activities on the community and on health is also high on our agenda”

In the banking sector, we have undertaken several engagements that have dealt with customer mistreatment as well as bribery and corruption. Following revelations in late 2016 that Wells Fargo had created millions of fake accounts and aggressively cross-sold products to customers, for instance, we wrote to and met that Chair for one-on-one discussions. A key priority was ensuring an overhaul of the board that had overseen the aggressive sales culture and weak internal controls. Since then, the Chair has replaced all the longstanding directors and overseen a shake-up of senior executives and strengthening of internal controls. We continue to monitor the situation.

HOW CAN ASSET MANAGERS DRIVE MARKET-WIDE CHANGE?

Asset managers often have a powerful voice when it comes to company engagement, but can also build networks through joining industry collaborations to amplify overall impact. In the end, rising inequality is a systemic problem that demands a broad-based policy response. Governments naturally take the lead, but asset managers can play a contributory role. Ultimately, we all have an interest in promoting a stable society as this underpins sustainable economic growth.

We therefore seek to contribute to policy efforts, focusing specifically where we believe we can add value. When it comes to inequality, we have supported a range of initiatives from sector-specific actions like the Investor Mining & Tailings Safety Initiative[2] to the Workforce Disclosure Initiative[3], a broader effort to drive more transparency from companies on how they manage workers. The latter is vital in ensuring investors have the information to underpin engagements aimed at improving workforce treatment.

The impact of company activities on the community and on health is also high on our agenda, for example the impact of plastics pollution. We have endorsed the Ellen MacArthur Foundation’s New Plastics Economy Global Commitment[4], which aims to tackle the growing problem of plastic packaging. We recently published our own Climate Pledge to ensure we are not exacerbating human suffering that arises from climate change.

The collective failure of asset owners and managers to properly monitor and hold executives to account is a major weakness with capital markets. When it comes to inequality, investors have an important role to play. Asset managers provide a critical link in the ownership chain, and have a responsibility to implement their votes and company oversight in a way that aligns with underlying shareholder interests. Executives will only be held to account when asset managers are.

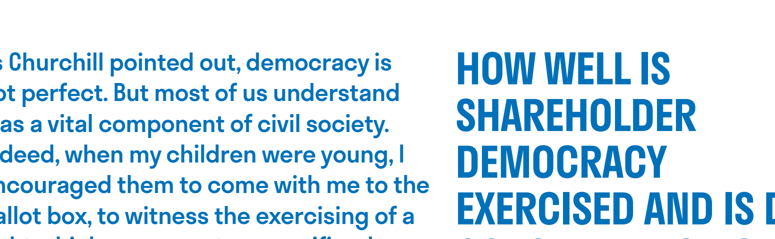
1 Economic Policy Institute. Figures based on stock options valued at the point when they were cashed in. **2** https://www.churchofengland.org/investor-mining-tailings-safety-initiative **3** https://shareaction.org/wdi/ **4** https://www.newplasticseconomy.org/projects/global-commitment

SHAREHOLDERS MUST EXERCISE THEIR DEMOCRATIC RIGHTS

“Democracy is the worst form of government apart from all the others”

Winston Churchill

DAVID PITT WATSON
CLIMATE ACTIVE ADVISORY PANEL



As Churchill pointed out, democracy is not perfect. But most of us understand it as a vital component of civil society. Indeed, when my children were young, I encouraged them to come with me to the ballot box, to witness the exercising of a right which our ancestors sacrificed so much to secure.

However, we are more reticent when it comes to recognising the importance of economic democracy. Many people I speak to, though they are perfectly well educated, are entirely unaware that their pension, and any other investments they have, confer democratic rights. In the UK, every year, every director of every public company has to stand for election. Director remuneration is subject to approval through the ballot, as is the appointment of the company’s auditor.

Who enjoys this right to vote? It is the shareholders. Those shareholders are the millions of people saving for a pension. They are individuals and families setting aside their wealth for coming generations. They are endowments and charities trying to secure their future.

All of these shareholders have an interest in ensuring that the companies they invest in are well managed, that they trade purposefully and profitably, and that they avoid damage to the society and environment in which we all live.

So you might have thought that we would all take an active interest in who is on the board of the companies we invest in. Unless we do, boards of directors are largely unaccountable. When it comes to a general election, we know that exercising our vote is an important part of maintaining civil society, and consider it with care. But similarly, if we want to create a civil economy of trustworthy and prosperous companies, votes must be cast with the same consideration.

HOW WELL IS SHAREHOLDER DEMOCRACY EXERCISED AND IS DUE CONSIDERATION GIVEN?

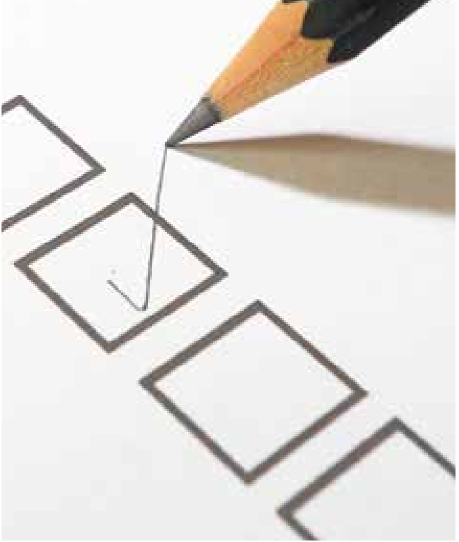
In some aspects, we have reason to be cheerful. Twenty-five years ago, perhaps 20% to 30% of shares would cast their vote. Today, it is more like 70%.

But when it comes to whether due consideration is given, the evidence is more mixed. This is in part for practical reasons. A big index fund manager broadly invested across many geographies might hold shares in thousands of companies. Each company might require ten votes. That is why fund managers often – perhaps too often – rely on recommendations from proxy agencies, companies which specialise in giving advice to shareholders on how to vote.

“In the UK, every year, every director of every public company has to stand for election”

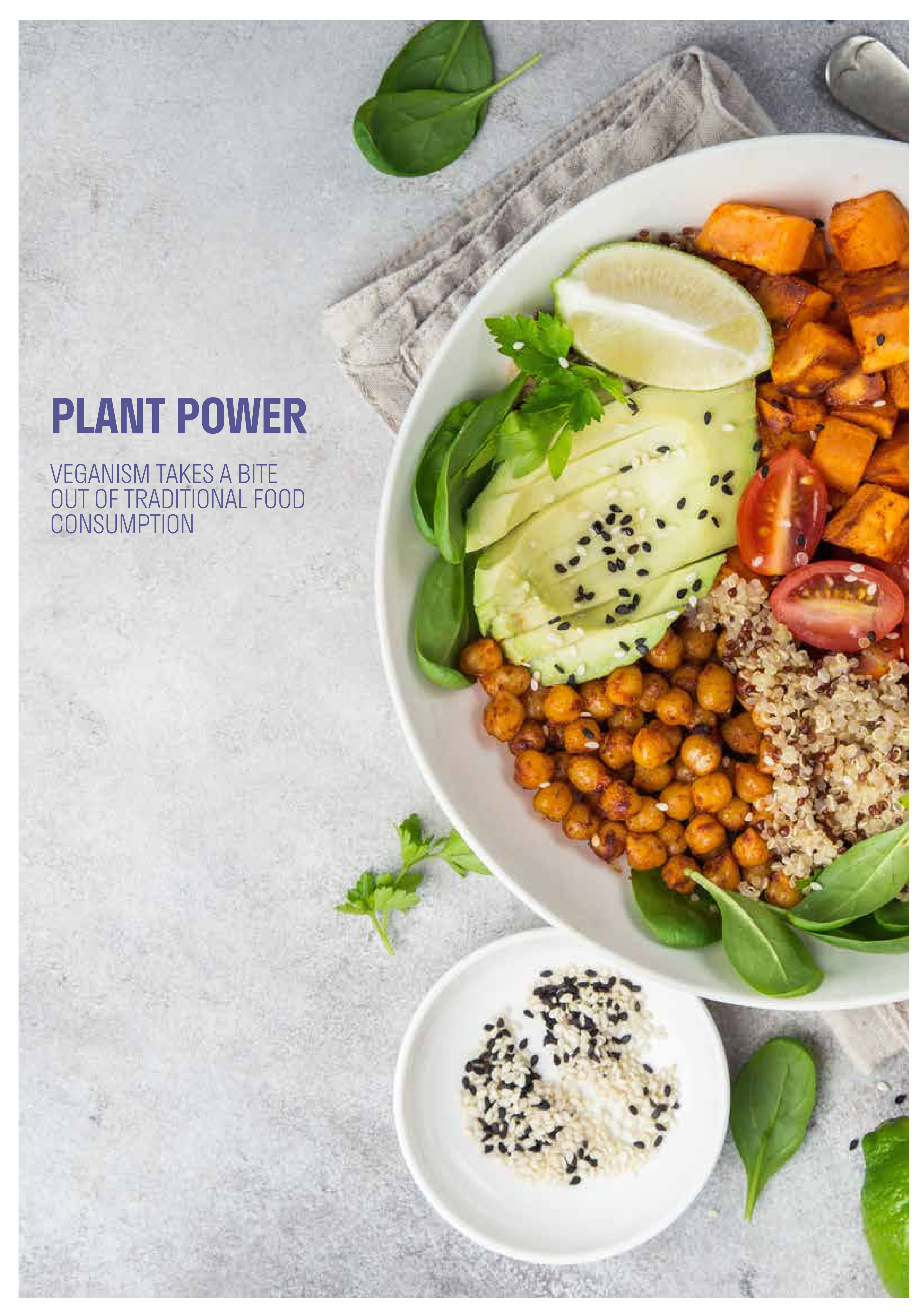
However, fund managers can be lazy and simply vote thoughtlessly for management proposals, hoping that others will have raised any difficult issues. Indeed, given that almost every vote is passed with more than a 90% majority, there is some evidence that this may be happening.

In all the examples I have given, it is a fund manager who is casting the vote. But the investment usually belongs to someone else: an endowment, a pensioner, an individual. It is absolutely critical that those whose funds are being managed know exactly how their shares are being voted.



Here is one example of how the system can easily fail, if shareholders are not on their toes. I have just stepped down as Chair of the £400 million endowment at NESTA, a charity dedicated to promoting innovation. One question we asked of our fund managers was whether they might be approving bonus packages for company directors that would encourage them to generate short-term results at the expense of long-term investment in innovation. None of the fund managers had even thought about it. And it turned out that this was exactly what they had been doing. That meant that NESTA’s endowment was being managed in a way which was in direct conflict with our beliefs. Our votes were discouraging long-term, profitable investment. We resolved never to appoint a fund manager who had not given proper consideration to voting.

No one is claiming democracy is perfect. But when I took my kids to the ballot box I wanted them to learn that the considered exercise of democratic rights was a foundation of a civil society. Proper exercise of shareholder votes is similarly important if we want to create a prosperous and sustainable economy.



PLANT POWER

VEGANISM TAKES A BITE OUT OF TRADITIONAL FOOD CONSUMPTION

JENEIV SHAH
FUND MANAGER

"There are signs that society's new consciousness around eating has disrupted the market

To meet health, environmental and food production targets, a recent white paper from the EAT-Lancet commission[1] recommended a halving of red meat consumption and a doubling of fish and plant-based proteins. Society needs to find a sustainable way to produce food for a growing population. But the transition to a more sustainable global food system is challenging.

One response to the challenge is the adoption of vegetarian or vegan diets. Veganism is now one of the fastest growing trends in the food industry. According to a recent survey conducted by Bernstein[2], more than a third of millennials in the US value vegan or vegetarian attributes when purchasing food – a significant increase of 162% from 2015.

WHY VEGANISM?

We attribute the rise of veganism to three main factors. Firstly, the rise of intensive animal farming practices means that concerns over animal welfare have intensified. Secondly, an increasing number of academic studies have highlighted the link between certain medical conditions and excessive consumption of red meat. Both of these factors are likely to have contributed substantially to the rise of veganism or reduced-animal-protein diets.

The most significant driver in recent years is likely to be climate and environment considerations. Consumers are increasingly aware of the livestock industry's carbon footprint, with the industry representing approximately 14% of all greenhouse gas emissions globally[3]. Media attention has also highlighted the wider sustainability challenges the food industry faces when it comes to its impact on soil, water and biodiversity.

Concerns around the environment are not going away. Popular shifts towards a new consciousness around the ethical and wellness impact of eating animal protein are unlikely to backtrack. We believe this is a powerful long-term trend in its infancy, rather than a temporary fad. Consumers are starting to think about how food choices have an impact on animals, humans, and the planet – a dramatic change from the many decades of mass production of food at any cost.

MOCK MEATS AND MYLKS

Companies that have spotted the opportunity to capitalise on this long-term trend have benefited. Initially led by alternative dairy products, the development of alternative non-animal forms of protein has received extensive private funding and venture capital for more than a decade. Soy, almond, coconut and oat milk are all widely available on supermarket shelves today. In fact, alternative milk almost doubled its category share in the US retail channel, from 7% in 2009 to about 15% today[4].

The past year has also seen the rise of alternative meat substitutes. Beyond Meat, with its range of pea-extract-based alternative meats, was the first of these companies to IPO. These products are now widely available across the US and at Tesco in the UK. Another rival player is Impossible Foods, producing a soy-based burger with the taste, texture and artificial 'bleed' of traditional animal meat. It uses a naturally derived chemical called 'heme' to give its patty these characteristics.

VEGANISM: NOT JUST FOR VEGANS

There are signs that society's new consciousness around eating has disrupted the market even for those who are unwilling to make the permanent switch to veganism. Both meat substitute products are aimed directly at animal-protein consumers rather than vegans. In fact, a major challenge for these companies is how to make alternative meats taste like traditional animal meat, to persuade consumers to make the switch. The three major listed flavour companies – Givaudan, IFF and Symrise – invest a rising proportion of their research and development budgets in new solutions to recreate the taste of meat. These companies are also specialists in natural flavourings which enhance the typically bland pea and soy ingredients that make up the bulk of the patty.

TRANSFORMING THE FOOD SYSTEM

A reduction in consumption of meat and dairy would reduce the food industry's carbon footprint. There are also other indirect benefits: fewer pollutants from livestock farms in rivers; more efficient land use and a reduction in the razing of forestry for grain production; improvements in health and wellness that could see a reduction in heart disease and less strain on public healthcare systems.

1 Source: Food in the Anthropocene: the EAT-Lancet Commission on healthy diets from sustainable food systems, Eat-Lancet Commission, 2019

2 Source: Bernstein US Food Survey, 2019

3 Source: UN FAO, Rome, 2013

4 Source: Euromonitor, 2019

‘EDEN BONDS’: CAN MONEY GROW ON TREES?

ISSUING GOVERNMENT BONDS LINKED TO RE-WILDED LAND COULD CREATE MASSIVE ENVIRONMENTAL BENEFITS

We must respond to the call of the forest," said President Macron of France at the close of the August 2019 G7 summit. Set against such powerful rhetoric from many world leaders on the need for action on biodiversity loss and climate change, the G7 pledge of €20 million to help fight forest fires in the Amazon seemed to many a bewilderingly small sum.

Ahead of the summit, the IPCC published a Special Report on Climate Change and Land providing governments with a thorough scientific analysis of global land use and another stark warning of the immediate need to radically change human behaviour to halt further climate damage.

THE LOSS OF ECOSYSTEMS IS ALREADY A THREAT TO THE HUMAN SPECIES

Land-use change causes a quarter of man-made emissions. Substantial alterations are required to agriculture and timber management to reverse land degradation, desertification and carbon emissions. The report further amplifies the ‘tragedy of the commons’ laid out by the IPBES in their May 2019 Global Assessment on Biodiversity and Ecosystem Services. This described how “the loss of species, ecosystems and genetic diversity is already a global and generational threat to human well-being”.

These thorough scientific reports on land use suggest a serious high-level reappraisal is required of how humanity considers and manages the earth’s land resources. The output the world needs from land today is not just monoculture grain production on an excessive scale, but carbon absorption and biodiversity.

Policy makers have an extraordinary historic opportunity to initiate massive change to land use at a time when a set of other circumstances in the wider world may help significantly with implementing it – record low bond yields, changing technology and a new public environmental awareness all support policy change.

THE CONFLICT BETWEEN LAND USE AND CLIMATE CHANGE

Part of the reason we find ourselves with this seeming conflict between land use and climate change is that current economic structures have encouraged the conversion of natural capital into financial capital. The result has been that a high proportion of viable land has been cleared for agriculture. While much of this has been rationalised by the inbuilt instinct of national leaders to keep food prices low and create national food security, the reality is that supply of grains now greatly exceeds natural food demand. Over the course of the twentieth century, mechanisation, hybrid seeds and intensive chemical use allowed crop yields to increase by three or four times.

However, over the last 20 years, government policies on biofuels – combustion fuels derived from calories in plants – have compounded ecological damage. By subsidising and mandating

HENRY BOUCHER
DEPUTY CHIEF INVESTMENT OFFICER

“Perhaps the answer is instead to change the policies to support the rural population in other ways.”

the use of crops for biofuels, governments hoped to create additional demand in an attempt to support agricultural crop prices, which have struggled to keep up with inflation in recent years (Figure 1). But biofuels contributed to land-use change. Previously unspoilt forest and grasslands have been cleared to grow biofuels or replace the food crops that were diverted for biofuel production elsewhere.

The lack of environmental logic inherent in biofuel policies that contribute to land-use change would appear to make them an easy first step for reform. Yet, there is a risk that removing these and other agricultural subsidies would have a significant impact on rural economies. Grain prices would almost certainly drop and so would land prices. Perhaps the answer is instead to change the policies to support the rural population in other ways.

WHAT STEPS CAN WE TAKE TO CONTROL LAND SUPPLY?

The UK is among several governments contemplating paying subsidies for ‘public goods’ such as environmental enhancement, rather than for over-production of crops. This could be taken a step further to include explicit control of land supply. If governments were to buy agricultural land from farmers at a set price, it could be retired from agricultural use and re-wilded to provide the environmental public goods required. From the farmer’s perspective, the capital would allow the repayment of loans and support the injection of capital into rural economies, helping to buffer the loss of income from lower crop prices as price support mechanisms are withdrawn.

What would governments then do with the land? This is where creative thinking is required. At the same time as society begins to recognise the environmental crisis it faces, in the financial world interest rates have plunged close to zero. Indeed, trillions of dollars’ worth of government bonds now offer negative yields. This leaves long-term savings institutions such as pension funds, insurance companies and endowments with nowhere to invest safely and still earn even a small return. Potentially there could be huge demand for a secure asset that can provide a better yielding substitute to conventional government bonds, particularly in Europe and Japan.

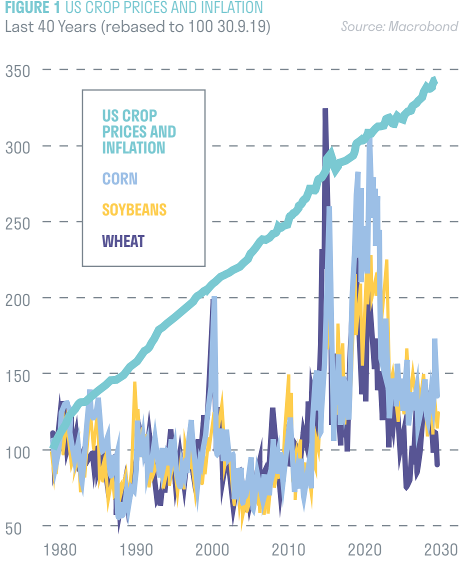
A NEW CLASS OF BONDS?

The green bond market is already established – as of October 2019, several tens of billions of dollars of green bonds have been issued, with a range of environmental projects financed by the proceeds. But only a small proportion relate to land use and this is just one leaf in the forest compared with the true scale required.

‘Eden bonds’ would be a new class of government bonds with the ability to revert land to a natural state. They would be issued to investors on a long-term basis but structured as a lease on a parcel of re-wilded land. That land will then be repurchased by the government at a ‘gilt-edged’ fixed price in, say, 50 years. In the meantime, the government pays a small interest rate for the guarantee that the land remains uncultivated and that a local workforce is employed to manage the transition back to the wild and to police it. The holder of these ‘Eden bonds’ could even earn additional income by selling carbon credits and credits for providing other public goods, including the restoration of populations of endangered species. The holder of an Eden bond has to work harder for their return, but it will be a higher return than on a conventional government bond.

The Paris Climate Agreement of 2015 set out three long-term goals: the first is to limit global average temperature rise, and the second is to increase the ability to adapt to climate impacts. The IPCC Land report highlights that without extraordinary changes to the way in which land is utilised, neither of those first two goals will be met.

FIGURE 1 US CROP PRICES AND INFLATION
Last 40 Years (rebased to 100 30.9.19) *Source: Macrobond*



What is also clear is that changes to the way in which land is utilised will only come if the third (and oft-overlooked) long-term goal is met. The Paris Agreement also committed to make “finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development”. Given high demand for secure, positive-yielding assets, policymakers now have the opportunity to transform our approach to land use by aligning financial flows with urgently needed climate stabilisation objectives.

THE YEAR RESPONSIBLE BOND INVESTING WENT MAINSTREAM

AS THE SARASIN RESPONSIBLE GLOBAL CORPORATE BOND FUND REACHED ITS THREE-YEAR ANNIVERSARY, WE REFLECTED ON WHAT DOES AND WHAT DOESN'T CONSTITUTE ETHICAL INVESTING

2019 has seen a mass change in climate consciousness with activists such as Greta Thunberg and the Extinction Rebellion group achieving household name recognition. In UK corporate bond markets, it is really the first year in which the notion of responsible bond investing has moved to the top of client priorities.

But what exactly does 'responsible' mean? In brief, it means marrying analysis of environmental, social and governance (ESG) factors to traditional financial analysis when deciding which companies to lend to. Since adverse ESG developments can lead to material underperformance of an issuer, it is expected that this will lead to superior long-term returns.

The notion of ethical investing goes back hundreds of years when it was associated with the Church. More recently, its evolution can be traced via the mass divestment by professional money managers from apartheid South Africa in the 1970s and 1980s.

ETHICAL INVESTING 2.0

Bond investors' first major encounter with ESG risk was in the mid-1990s when tobacco credits experienced severe stress due to a wave of State-level litigation in the US. Next came the accounting scandals of the early 2000s (Enron, WorldCom, Tyco, etc) which revealed glaring governance issues across corporate America.

More recent instances of ESG failure include the Deepwater Horizon oil rig disaster in 2010 (BP) and the defeat device scandal in 2015 (Volkswagen). Both episodes resulted in severe underperformance of the companies' bonds. Rigorous ESG analysis does not guarantee that an investor can always avoid treading on such landmines. However, it does allow an investor to better gauge the credit risk premium, or spread, on the bonds that adequately compensates not just for risks related to the strength of the company's balance sheet, but also for the contingent risks that may arise from ESG factors.

For example, a five-year Volkswagen bond in GBP yielding only 0.7% more than UK gilts – as it would have done in early 2015 – might not be attractive enough for us to have considered owning, given the high degree of ESG risk associated with the auto sector. On the other hand, a Volkswagen bond yielding 2.5% more than gilts post the defeat device scandal just might. (This judgment would include the exit of culpable senior management and a clear shift in corporate practices at Volkswagen.)

Environmental and social considerations tend to be quite similar for both equity and bond investors. It is when it comes to governance that there is some divergence. Factors like ownership structure and operational controls matter for both. However, when it comes to a company's dividend policy or attitude to its credit rating, shareholder and bondholder interests can be diametrically opposed. Having said that, the interests of equity investors with a sufficiently long-term focus may be more closely aligned with bondholders in the sense that neither's interests are best served by an overly aggressive, and ultimately unsustainable, dividend policy.

ANTHONY CARTER
FIXED INCOME FUND MANAGER

Hence our fondness as responsible bond investors for mutual structures and for companies with a regulatory requirement to maintain an investment grade credit rating. Dwr Cymru (Welsh Water) is an example of an issuer that ticks both boxes, contributing to its high score for governance on our internal ESG credit ratings system.

In fact, well over half of our credit book consists of issuers that have no publicly listed equity. This also serves to illustrate that responsible bond investing allows clients to support a different range of impact sectors from responsible equity investing, notably in areas such as education, housing, and transportation and renewable energy infrastructure.

EMBEDDING INTO THE INVESTMENT PROCESS

A common misconception about ESG investing is that it just simply involves negative screening, i.e. excluding investments in 'sin' sectors, such as tobacco or armaments. But it means much more than that. It means having a thematic bias to invest in sectors whose activities create positive externalities, ilike wider gains for societies at large, such as renewable energy infrastructure or social housing.

> "Environmental and social considerations tend to be quite similar for both equity and bond investors"

Nor need the responsible approach entail any kind of limitation on the returns that are possible. With the exception of tobacco, most sectors that score poorly on ESG criteria, such as aerospace and defence, alcohol, oil and gas and automakers, tend to offer relatively unattractive yields (to say nothing of the asymmetric price risks posed by their occasional highly publicised ESG difficulties).

The reason is that they tend to be long-established companies which are highly familiar to investors (expressed less positively, they are frequently old industries falling into secular decline). They often trade at rich valuations because they offer investors some degree of diversification away from the core credit sectors of utilities, financials and telecoms.

On the other hand, many of the infrastructure-related names and housing associations to which we lend tend to be newer and less well known, hence investors require an "unfamiliarity premium" to hold them, as well as a liquidity premium given their total outstanding issuance is typically much less.

As ethical considerations become increasingly important for clients, we are likely to see a surge in demand for bond funds with a specifically responsible or sustainable focus. Companies need to respond to this evolving demand in their approach to corporate ESG or ultimately risk being shut out of debt capital markets entirely.

TACKLING GOOD AND BAD PRACTICES RELATING TO THE STEWARDSHIP OF LONG-TERM ENDOWMENTS

RICHARD MAITLAND
HEAD OF CHARITIES

As an increasing number of UK charities seek to invest more responsibly and address environmental, social and governance (ESG) issues within their endowment portfolios, it seems right to ask if they are getting what they want from the asset management industry. What are the good and bad practices when it comes to the 'stewardship' of client assets? How can a charity identify 'greenwashing' (a term coined by environmentalist Jay Westerveld in 1986 to describe misleading corporate environmental claims)? Asset managers have to step up their reporting of ESG issues, particularly around climate change, and clients need to hold their asset managers firmly to account.of client assets?

> "ESG issues should be a fundamental part of the risk and reward analysis of every company"

CAREFUL VERSUS CARELESS

In the broadest sense, it is possible to distinguish the attributes of those managers one might describe as 'careful' from those who appear to be 'careless'. A careful and responsible asset manager should think long term, consider the broader – and often complex – relations between society and a business and engage actively with companies to drive positive change. In contrast, the 'careless' brigade often over simplify to make their lives easier, spend little time and resource actively engaging and rarely consider the broader policy issues that may put their clients' capital at risk. Above all, trustees need to beware of 'greenwashing' from managers who jump on the ESG bandwagon and make statements that may not stand up to scrutiny (see table opposite). Beware also those that 'outsource' and rely on external agencies for their ESG work.

STEWARDSHIP AS A MINDSET

We believe that stewardship is a mindset, which means thinking like owners of a business, and not simply shareholders. A key element of active management is engagement. It is important to speak out as shareholders, both in relation to companies, but also as part of wider 'policy work', which will shape the investment landscape and help promote the sustainability of returns.

As companies grow, their influence over society spreads. Executives of the world's biggest companies arguably exert more influence than the governments of many countries. One of the most controversial topics is executive pay and here, as in many areas, we find too few investment managers willing to stand up to the power of company boards. All too often, investors simply vote in line with management's recommendations. The FT conducted a survey last year, which showed that the world's largest fund managers voted in favour of pay awards more than 90% of the time. So far this year, Sarasin & Partners' has voted against 42% of pay resolutions in the UK and 50% in the US.

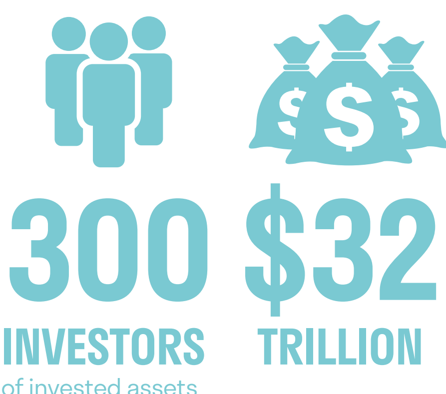
However, wider issues should be taken into account The issue is not limited to voting on Annual General Meeting resolutions. Asset managers should also address wider environmental and societal issues. No company is perfect and most have exposure to 'negative externalities', a term coined by economists to describe costs which are imposed on others without adequate compensation. This could be, for instance, harmful air or water emissions. Businesses that do this can be accused of exploiting 'natural capital' or exploiting 'social capital' in order to make 'financial capital'.

CLIMATE CHANGE – OUR GREATEST CHALLENGE

The greatest environmental challenge and externality of them all, is climate change. The major governments of the world finally agreed some common targets at the UN Paris Summit in December 2015 with a pledge to "keep a global temperature rise well below 2°C and pursue efforts to limit even further to 1.50C". Despite a number of issues, and reluctance from some parties, a new 'rulebook' was agreed that will act as an operating manual for all 196 countries when they come to report on their progress over the coming years. It will also provide guidance on the relative roles of both developed and less developed nations in mitigating their emissions and participating fully in the Paris process.

Serious action is needed to radically transform the energy system by reducing our net emissions to zero. Policies to tackle climate change still need to ratchet-up dramatically and if action is not taken, then climate stabilisation will prove impossible and so will follow material physical, ecological, societal and economic costs. Accordingly, 'Paris' as a specific objective may not be met, but the eventual manifestation of climate related impacts will become so material, that a cut to emissions must inevitably follow. At such a point, the transition away from a carbon intense economy is likely to be disorderly from a macro-economic, societal and asset pricing perspective. Crucially, we do not believe investment markets are yet discounting the consequences of such possibilities adequately, if at all.

Climate Action 100+ initiative, which brings together over



300 INVESTORS

$32 TRILLION

of invested assets

HOW TO TELL IF YOUR MANAGER IS CAREFUL OR CARELESS

Invests with a long-term horizon

Integrates ESG in fundamental analysis

Considers costs of negative externalities

Uses voting activity to encourage improvement in corporate behaviour

Holds results-oriented discussion with management

Engages with policy makers to encourage positive systemic change

Uses multiple sources of research and primary analysis

Focuses on short term share price movements rather than long-term corporate performance

Passively tracks an index or hugs close to it

Votes, but more as a 'box-ticking' exercise

Doesn't engage with companies where there are concerns

Keeps costs low by not devoting resources to ESG

'Greenwashes'

Blind adherence to generic research

TIME FOR EVERYONE TO TAKE ACTION

Everyone needs to play a part in driving change and that must include both asset owners and asset managers. At Sarasin & Partners, climate change is clearly identified as one of our five themes, which will shape investment markets in the decade to come. An increasing number of our charity clients have signed up to our 'Climate Active' strategy, which combines engagement and divestment to persuade companies to take faster action where we identify climate risks. For these clients, we will divest from any company where we do not believe enough progress is being made. Many managers focus too narrowly just on fossil fuel companies, but it is a wider issue across the investment spectrum from 'producers to users to consumers' and affects many different businesses. We have recently written to 35 companies seeking a commitment to the Paris goals and an alignment with a pathway towards zero net emissions.

In our follow up conversations with companies, too often we are told that no other investor has asked this question. This is not to say that other institutional investors are not active. Several are, and we form alliances with like-minded investors to increase the power of our voice wherever we can. For example, we are co-coordinators, alongside the Church Commissioners, of a large group of investor engagements with European oil and gas companies under the Climate Action 100+ initiative, which brings together over 300 investors and $32 trillion of invested assets. We are also leading an investor initiative to challenge companies and their auditors to ensure they are reporting to shareholders in a way that takes account of the Paris Climate Accord. All such efforts should be widely encouraged, while attempts at 'greenwashing' need to be robustly challenged.

VOTING SUMMARY

NUMBER		2012	2013	2014	2015	2016	2017	2018	2019
Total Number Of Company Meetings		636	638	741	969	968	1,165	1,171	1,226
Total Number Of Proposals		7,448	7,184	8,090	11,102	10,387	13,244	13,412	13,352
Votes Cast	For	4,720	4,986	5,807	8,288	7,728	8,570	9,171	8,721
	Against	1,312	1,418	1,332	1,631	1,681	2,354	2,611	2,770
	Abstain	5	56	63	118	61	101	131	129
	Withhold	171	173	126	85	84	83	79	100
	Did Not Vote	1,240	551	762	980	833	2,136	1,420	1,632

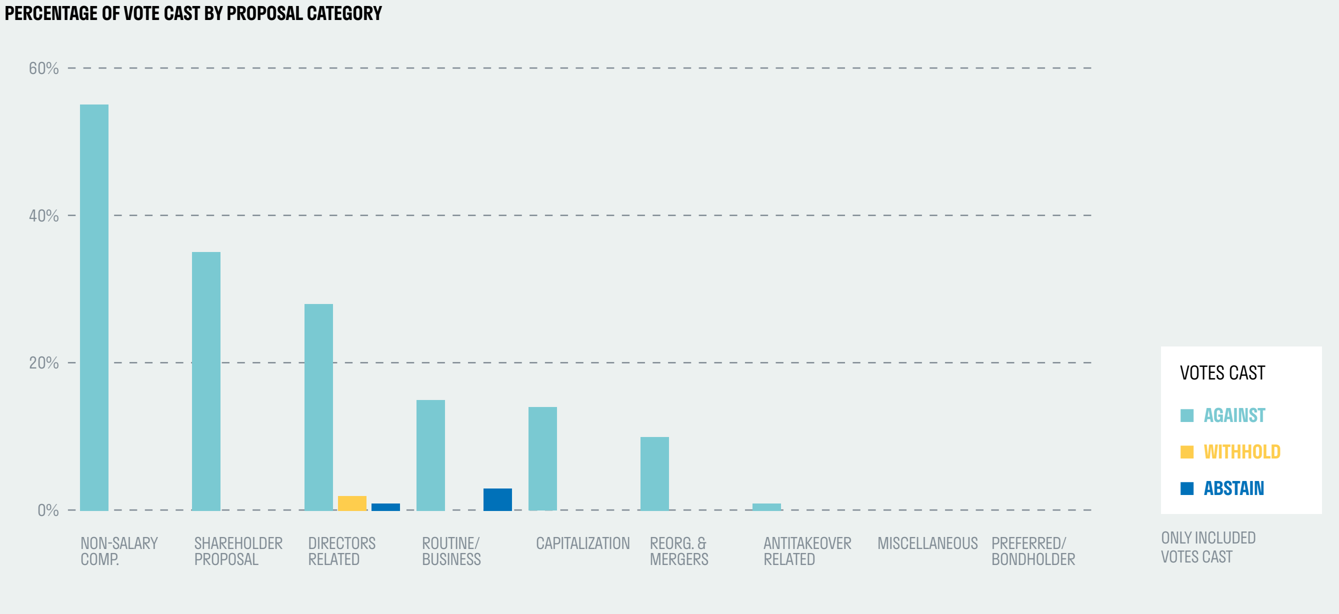
ANNUAL VOTING SUMMARY 2012 - 2019

%

100%
80%
60%
40%
20%
0%

2012 2013 2014 2015 2016 2017 2018 2019

VOTES CAST
FOR
AGAINST
ABSTAIN
WITHHOLD
DID NOT VOTE



COMPANY ENGAGEMENT

Engagement is an important component of our stewardship activities. Our engagement efforts with companies aim to improve governance and tackle key issues for shareholders. This allows us to hold company management to account and to encourage the development of high standards. Many of these engagements are ongoing and take place in confidence, but where possible, and where clear outcomes have been reached, we discuss the results. The following are recent examples of our company engagements.

ESSILORLUXOTTICA

The merger of lens maker Essilor and glasses frame maker Luxottica at the beginning of 2019 presented an attractive investment opportunity as the combined entity was expected to create synergies of up to EUR 600million and would dominate an industry which is growing but fragmented. However, the joint company's unorthodox and complex governance structure raised concerns that the leadership would fail to realise promised synergies. Under the new governance structure, Essilor and Luxottica representatives share equal executive power, with each side occupying half of the expanded 16-person Board. Disagreements over the search of the future Chief Executive Officer (CEO) became public and the share price of EssilorLuxottica suffered.

We have particular concerns over the power exerted by Luxottica's founder, Del Vecchio, who owns about 30% of EssilorLuxottica and Executive Chair. For the three years prior to the merger, as Chair of Luxottica, Del Vecchio replaced the CEO three times. Against this backdrop, we have written to all independent directors of the company to ask them to 1) accelerate the transition to a new CEO and demonstrate his/her independence from Del Vecchio; 2) appoint a lead independent director who minority investors can turn to for future dialogues, and 3) ensure an explicit link to synergy delivery in executive remuneration.

Governance conflicts continued to be a concern at EssilorLuxottica in the second quarter, so we increased our scrutiny and engagement effort. In a rather dramatic public spat, Hubert Sagnieres (Vice Chair and previously head of Essilor) issued a press release in March accusing Del Vecchio of attempting to take over the company without offering any premium to shareholders. In response, Del Vecchio filed an arbitration request with the International Chamber of Commerce claiming Essilor executives had violated the merger agreement.

While we believe the merged entity offers attractive opportunities for synergies, for these to be delivered the Board needs to work together. Infighting between the Essilor and Luxottica camps is clearly unhelpful and, if it persists, could put at risk the broader business prospects.

For this reason, a group of investors put forward two external board candidates at the company's AGM in order to break the deadlock and ensure minority shareholders' interests are represented in the boardroom. We discussed with the two candidates their plans to bring the two sides back together and supported their appointment. While we were disappointed that the Board decided to recommend a vote against the proposed directors, and they therefore failed to receive over 50 percent support, the fact that a majority of independent shareholders supported their appointment sent a strong message to EssilorLuxottica's leadership.

In response, the Board signed a settlement agreement promising to accelerate the integration process and simplification of the group structure, with Del Vecchio and Sagnieres handing over some of their executive power to subordinates. While these are positive steps, they fall short of the required changes we believe are necessary. Following the AGM, we wrote our second letter to all the independent directors at EssilorLuxottica setting out the steps we expect the board to take, including appointing new independent directors that can truly represent the combined group; succession plan for Del Vecchio and Sagnieres; an accelerated of transition to a new Chair and Chief Executive and the appointment of a lead independent director to whom minority investors can turn for future dialogues. We will scrutinise their response carefully and continue to closely monitor the situation.

ARAMARK

In the second half of 2019, we started to engage with Aramark, the US provider of food services, facilities services and uniform services company this quarter on a number of issues linked to its strategy, remuneration and communication.

We have significant concerns over Aramark's unclear strategy. It has not articulated well its growth drivers and margin performance, or related targets for the future. In short, the company needs to make clear whether it is prioritising growth or margin.

We also question whether the company is the appropriate owner of its Uniforms business and the international business, which are sub-scale. We are keen for Aramark to focus on contract catering where the company has scale, expertise, and a leading position.

When it comes to remuneration, while Aramark has had a weaker operational and financial performance than its direct peers (Compass and Sodexo), the Chief Executive Officer (CEO) was paid materially more than them. There are several reasons for this including a higher maximum annual bonus of more than 500% of salary (versus 200% for Compass and Sodexo); a higher long-term incentive (roughly six times salary in 2018, compared with less than five times for Compass and Sodexo); and a lack of appropriate peer benchmark in assessing performance. We are also concerned about the large severance package in change-in-control situation ($41.8 million) and its potential impact on company's strategy.

Recently, Aramark's CEO announced his plan to retire and we believe this is a good opportunity to push for overhaul of the remuneration structure for the incoming CEO and also to address the issues in its strategy and communication to the market.

PARTNERS AND INITIATIVES

CLIMATE CHANGE

Task Force on Climate-related Financial Disclosures (TCFD)

Institutional Investors Group on Climate Change (IIGCC)

Signatory of the Paris Pledge for Action

Climate Risk Reporting with ClientEarth

Sarasin Climate Active Expert Advisory Panel

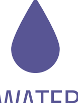
Sarasin Climate Pledge & Climate Action 100+ (CA100+)

The Climate Disclosure Project (CDP)

CIRCULAR ECONOMY

LAND

AIR



WATER

Fair Animal Investment Risk & Return (FAIRR)

Plastic Solutions Investor Alliance (PSIA)

Ellen MacArthur Foundation Plastics Initiative

SUPPLIERS

EMPLOYEES

30% Group Investor Initiative

Workforce Disclosure Initiative (WDI)

Collaboration with ShareAction

Sarasin Modern Slavery Statement

CUSTOMERS

BRIBERY & CORRUPTION

COHESIVE SOCIETY

Interfaith Center on Corporate Responsibility (ICCR)

The Local Authority Pension Fund Forum (LAPFF)

Sarasin Anti-Bribery and Corruption Statement

Social investment exclusions: tobacco, pornography, armaments, gambling, alcohol

BOARD STRUCTURE

OWNERSHIP RIGHTS

Asian Corporate Governance Association (AGCA)

Council of Institutional Investors (Cli)

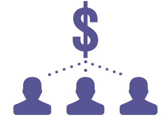
Australian Council of Superannuation Investors (ACSI)

Sarasin Independent Voting Policy

UK Corporate Governance Code

Show of Hands Initiative on Shareholder Voting

REPORTING & CONTROLS



EXECUTIVE RENUMERATION

BUSINESS ETHICS

Investors Coalition on Audit & UK Stewardship Code

Oxford Martin School Investment and Engagement Principles

Investors coalition on International Financial Reporting Standards (IFRS)

Corporate Reporting and Auditing Group, convened by the Investment Association

Investor Advisory Group of the Financial Reporting Council (FRC)

Signatory of the UN Principles for Responsible Investment (PRI)

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