Global Equity & Income Team

Our approach towards responsible investing

Philosophy: ESG integration as a financial opportunity and risk mitigation factor in the fundamental analysis

The Global Quantitative Equity and Income team's philosophy is rooted in a disciplined, data-driven approach to investing. This also applies to the team's Environmental, Social and Governance (ESG) integration approach. Mission critical for the team is to identify ESG-related factors that they believe enhance alpha and address risks across the market.

The investment team systematically incorporates ESG factors in its stock selection model with the belief that it enables exposure to companies with stronger ESG characteristics and an additional factor to add alpha for the portfolio, as companies that are focused on sustainability typically possess favourable quality characteristics.

> "Identifying companies that make progress on their ESG characteristics can generate a source of alpha for our clients"
>
> **Darren McKiernan**
>
> Senior Vice President, Portfolio Manager, Head of Mackenzie Global Equity & Income Team

How ESG factors are integrated in the investment process

ESG integration in the bottom-up analysis

Every company subject to investment analysis is also evaluated on ESG factors that are financially material to the specific company. Generally, the relevant ESG factors are industry specific based on proprietary views from the investment team. ESG factors are uncovered through the team's own research and engagements with companies in combination with external research providers such as Sustainalytics. High risk companies, including those with poor sustainability practices and rated low by external research providers, are subject to enhanced due diligence. ESG considerations are incorporated in the internal research reports, which are presented for debate and discussion at the team's weekly meetings.

The team incorporates these ESG factors into long-term financial forecasts in the Discounted Cash Flow (DCF) valuations on a stock-by-stock basis. In practice, the ESG analysis can lead to adjustment in overall growth rate assumptions of revenue forecasts, operating costs forecasts, discount rates, and/or terminal value. For example, lower growth rates can be given to chemical companies for products that are likely to be banned on health and safety grounds or a terminal value of zero can be assigned to technology companies whose core products could be at risk of obsolescence. In other instances, the team may decrease operating costs of companies in the materials sector that deploy new clean technologies to reduce emissions and adjust operating costs for changes in labor costs and tax rates.

ESG integration in the investment decision making process

The bottom-up analysis leads an ESG score of strong, neutral or weak for each company. This score is then combined with the team's fundamental company and industry-level research to arrive at a statistical confidence interval on the company reaching an intrinsic value target. This analysis drives the investment decisionand ultimately portfolio weightings.

Company scores, both ESG and non-ESG, are maintained and updated through the team's portfolio management platform. This tool provides a central depository of scores that can be challenged, reviewed and amended on an ongoing basis. These scores are reviewed while assessing financials and valuation models before making investment decisions. For example, for two securities with similar businesses and valuations, the team would buy or assign a higher weighting to the company with a better ESG score. Importantly, the team also values companies with improving ESG scores as these could be a source of alpha. In contrast, companies with deteriorating ESG scores are evaluated for a potential sell decision to avoid losses.

Engagement as a tool to be responsible active owners

The investment team are active owners and frequently engage with companies on ESG related issues as responsible investors. Engagement is both proactive and reactive, when appropriate. Proactive engagement is initiated internally whereby the team may choose to seek additional disclosures from companies in certain areas or engage with firms using best practices. Reactive engagement may be used to respond to reports of adverse ESG practices.

CASE STUDIES

ESG risk mitigation in the fundamental analysis of 3M

3M manufactured two controversial polyfluoroalkyl substance (PFAS) compounds, perfluorooctanoic acid (PFOA) and perfluorooctane sulfonate (PFOS) up until 2002. The State of Minnesota filed a lawsuit against 3M in 2010 alleging the company knew that these chemicals were toxic and that it polluted groundwater with the PFAS compounds. The complaint alleged that 3M "acted with a deliberate disregard for the high risk of injury to the citizens and wildlife of Minnesota." While 3M settled with the State of Minnesota in 2018 for $850m it still faces more than 300 individual and class action suits pertaining to PFAS liabilities. We incorporated a $10bn cost for PFAS-related liabilities in our DCF valuation analysis and decided to exit the stock.

The team's engagement with Nestlé

Nestlé is the largest packaged food company in the world. The team participated in an investor's roundtable in November 2020, to discuss Nestlé's new comprehensive ESG plan, including targets and timelines, with Chairman, and former CEO, Paul Bulcke. Most noteworthy was Nestlé's board integrating a new ESG framework into executive remuneration for the first time in company history. The discussion touched on all the ESG risks and Nestlé's efforts to address them: from diversity and inclusion globally to their new packaging institute to their detailed plan and milestones for reaching a net zero carbon footprint. The net zero plan includes reaching 20% reduction of emissions by 2025, 50% by 2030, and being net zero by 2050. Discussions engaged at a reasonably detailed level as to how this could be achieved by divisions from manufacturing to distribution, including reformulating SKUs and expected headwinds to financial performance. Other relevant targets include 100% reusable or recyclable packaging by 2025; 100% deforestation free by 2025, 100% certified sustainable coffee and cocoa by 2025, and sourcing 50% of ingredients through regenerative agricultural methods by 2030. In a one-on-one conversation in June 2021 with current CEO Mark Schneider, the team engaged on his perspective of ESG in compensation; the net impact of the current inflationary environment on the ROI of their climate change investments; and challenges to improving the overall healthiness of Nestlé's product portfolio.

Mackenzie Global Equity & Income team

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Learn more about the Mackenzie Global Equity & Income Team here.

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