ESG research playbook: focusing on what matters

HOW TO INCORPORATE ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) RESEARCH AND RATINGS INTO FUNDA-MENTAL SECURITY ANALYSIS CAN BE A VEXING QUESTION FOR INVESTORS. The connection of ESG issues to equity returns isn't always clear, and disconnects can persist for companies that screen well on fundamentals but poorly on ESG. As ESG-focused investors with extensive fundamental investing experience, here are some ways we help our colleagues think about applying ESG to their investment process.

Yolanda's perspectives



Yolanda Courtines, CFA Equity Portfolio Manager

Look for red flags. I see ESG as a cost-of-equity scaler. The more material ESG red flags there are, the more concerns the market may have about a company's financial risks. These concerns can reduce the likelihood for strong fundamental performance to translate reliably into strong share-price performance over the long term. Conversely, the more a company's ESG profile improves and concerns abate, the more the stock's discount rate in the market can fall.

Engage. If an ESG rating seems at odds with our fundamental view on a company, our responsibility is to dig in and engage. ESG ratings are inherently challenging, as they attempt to aggregate multiple data points into a single numeric signal of how a company treats its stakeholders, including employees and suppliers; approaches environmental issues like carbon emissions; and manages governance topics like executive pay, succession planning and capital allocation.

Understand materiality. Engagement is often the best (and only) method of determining what is material. Investors should understand what underpins a poor ESG score and assess why a topic might be material for the company or sector in question. Flagged ESG vulnerabilities often lack any precedent of material financial costs or discernible impact on share price; this can be frustrating to owners of shares that screen poorly on ESG.

Think objectively about ESG vulnerabilities and their relationship to fundamentals. If an otherwise outstanding company strengthened a major ESG weak spot, could that reduce earnings risk over time? If an investor is constructive on a company's fundamental story, why not raise the ESG topics of concern and push a company to do better? Some studies have shown improving ESG ratings to correlate with positive stock-price performance. Why wouldn't investors engage on issues that could have strategic, legal or regulatory relevance over time and improve returns? ESG ratings can help us know where to focus that attention.

Mark's perspectives



Mark Mandel, CFA Equity Portfolio Manager

Do the research and focus on financial materiality.

We work with our ESG Research Team to identify and analyse the ESG issues that we believe are most relevant to investment outcomes for our clients. The Sustainability Accounting Standards Board (SASB) is an incredibly helpful resource for identifying factors that matter most, industry by industry.

Understand how ESG fits into your mosaic. Our goal, always, is to protect capital and compound investment returns for our clients over time. ESG is one of many tiles in the mosaic that investors should consider, and that tile can be bigger or smaller, depending on the investor's philosophy and process. ESG will never be the only reason to buy or sell; just as a single fundamental or valuation input wouldn't either.

Consider time horizon. Material ESG factors are often long term in nature, so multiyear holding periods can be necessary to prove the efficacy of ESG analysis. This is not to say ESG matters only to long-term holders, it's just that the longer the horizon, the more it matters. Investing in stocks with materially negative ESG issues is running against the clock — similar to growth-oriented investing, where one tries to extract alpha ahead of reversion to the mean. This can be a good way to make money; one just needs to be aware of the risks.

Remember that the future will not look like the past.

Think about climate change and the transition to a low-carbon economy, for example. Which companies will succeed or struggle in a less-carbon-intensive world? Just because something is challenging to measure today, doesn't mean it won't have a significant impact on financial outcomes in the future.

Finally, I believe every investor should be able to:

Articulate material ESG issues for each holding. The investor should note inherent risks or opportunities missed and be able to convey why a company will be able to overcome these issues during the investor's time horizon.

Factor these issues into valuation and price targets.

One company's valuation might be structurally lower than a competitor's because challenging E, S or G issues meaningfully increase its long-term financial risks (or missed opportunities). As more asset owners raise the bar for ESG, could those relative peer-valuation gaps widen?

For a deeper look at our approach to ESG-forefront investing, please visit our website https://www.wellingtonfunds.com/en-gb/intermediary/ investment-ideas/sustainable-investing/stewardship/

For more information, please visit www.wellingtonfunds.com/sustainable-investing or contact:



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INVESTMENT RISKS

All investing involves risk. If an investor is in any doubt as to the suitability of an investment, they should consult an independent financial advisor.

Risk to capital: Investment markets are subject to economic, regulatory, market sentiment and political risks. All investors should consider the risks that may impact their capital, before

investing. The value of your investment may become worth more or less than at the time of the original investment.

Manager risks: Investment performance depends on the investment management team and their investment strategies. If the strategies do not perform as expected, if

opportunities to implement them do not arise, or if the team does not implement its investment strategies successfully; then a strategy may under-perform or experience losses.

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