

Q&A: Environmental, Social and Governance factors

ESG is one of the most discussed topics in the press today. Below we seek to provide clarity both on the wider trends, and how we apply ESG to the five Embark Horizon Multi-Asset Funds (Horizon).

Why did Embark Investments sign up to the UN Principles on Responsible Investment?

There were many reasons we joined the 7,000 firms from 135 countries that had already signed up:

- Embark Investments is committed to the integration of ESG considerations into the Horizon fund range, as it continues to evolve the Horizon funds with changing financial markets and customer needs.
- The six UN principles match the framework that Embark Investments employs to oversee the Horizon funds, helping us to embrace an international standard.
- We believe increased adherence by the financial sector will benefit UK retail investors, our economy, and wider society as a whole.

What are the UN Principles on Responsible Investment (UNPRI)?

By becoming a signatory, Embark Investments as Authorised Corporate Director (ACD) and, in turn, the Horizon funds, commit to incorporating ESG factors in the investment process. Here is the signatory commitment:

“We have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

Principle 1: *We will incorporate ESG issues into investment analysis and decision-making processes.*

Principle 2: *We will be active owners and incorporate ESG issues into our ownership policies and practices.*

Principle 3: *We will seek appropriate disclosure on ESG issues by the entities in which we invest.*

Principle 4: *We will promote acceptance and implementation of the Principles within the investment industry.*

Principle 5: *We will work together to enhance our effectiveness in implementing the Principles.*

Principle 6: *We will each report on our activities and progress towards implementing the Principles.*

The Principles for Responsible Investment were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social and corporate governance issues to investment practices. The process was convened by the United Nations Secretary-General.

In signing the Principles, we publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles.”

Horizon by Embark

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How do you see the role of Embark Investments as ACD in ESG?

Our mission as ACD is to ensure the Horizon funds offer a user-friendly investment package for financial advisers, which fulfils the responsible investment aspirations of the investors in a way that does not curtail their financial goals, but enhances them. Our funds should therefore evolve with the times, adapting to trends in investments and society.

We have increasingly enhanced our scrutiny of ESG factors, pro-actively engaging with the appointed investment manager, Columbia Threadneedle, to understand its approach, provide our feedback, and monitor its processes. When the Horizon business transitioned to Embark Group on May 1st 2020, we issued an ESG statement on the Horizon website. More recently, the ACD has become signatory to the UN Principles of Responsible Investment (UNPRI).

The ACD has included oversight of Columbia Threadneedle's approach in its regular reviews, monitoring the portfolio through a number of ESG related indicators on a monthly basis.

How would you summarise the different approaches fund groups are following on ESG?

There may be as many approaches as there are funds, so anything we say could oversimplify things. The three ingredients of ESG provide different lenses to look at investments, which further complicates things. But a broad brush summary could be:

- **No ESG:** The fund manager does not look at ESG factors when making investment decisions. This was often the case in the past, although good or improving governance (aka stewardship) has been something analysts and portfolio managers have looked at for many years. ESG has taken off as a trend in the UK and Europe, but in the US the 'no ESG' approach remains prevalent.
- **Integrated ESG:** The manager does not systematically exclude certain sectors on ESG grounds – although can have red lines – but will critically appraise companies from an ESG angle, looking both at returns and risks. When meeting the management of firms, analysts will challenge them on how their business models are evolving to cater for trends like reduced carbon emissions, a changing climate, ensuring their supply chain respects human rights, or including checks and balances to align the incentives of management with those of investors. Taking the example of integrated auto manufacturers, an analyst can look at aspects such as shifting to electric motors, increasing the energy efficiency of their manufacturing processes, or monitoring the carbon footprint of their suppliers. We note that with the integrated approach, ESG is just one factor the manager takes into account, next to many other inputs like valuations, earnings growth, etc.
- **Exclusion-based ESG:** the fund manager selects the most attractive securities after systematically excluding certain (sub-)sectors and companies because they do not fit a pre-defined set of ESG criteria. A variant of this approach are ethical or religious-based funds, which have been around for a while and could follow a Christian, Humanistic or Muslim philosophy, as well as non-religious ethical considerations. Exclusions can be made for oil, tobacco, armaments, alcohol or many other areas. Likewise, companies could be excluded based on less than satisfactory governance arrangements (unacceptable share structures which give minority shareholders majority votes, or lack of board diversity). Though this approach is not yet mainstream, it is receiving a lot of publicity and is seen by some as the acceptable face of capitalism and investing.
- **Impact investing:** a more focused approach even than exclusion-based, where managers only invest in sectors, projects or companies that provide specific outcomes. These funds are less likely to be multi-asset like Horizon, and typically focus on providing capital to specific areas of the economy. These funds are not always available as open-ended retail funds, as many tend to be project-oriented and operate in the private markets. Sometimes financial advisers use these in their CIP to blend with more traditional multi-asset investments. Examples might be funds investing in the hydrogen sector (an alternative to the car batteries being developed by firms like Volkswagen or Tesla), a green energy fund (voltaic cells, windmill parks) or an Africa infrastructure vehicle.

Which approach is Horizon following?

We use the second, integrated approach, which is embedded within our investment process. The investment professionals at Columbia Threadneedle have access to in-house ESG data and analysis to help develop investment theses. Fund managers and analysts collaborate with the dedicated Responsible Investment (RI) team to improve understanding of material ESG risk management and to identify potential for sustainable opportunity. The multi-asset experts responsible for the five Horizon funds, as well as the portfolio managers of Horizon's underlying Columbia Threadneedle sub-funds, are therefore supported in their decision making by the RI team. Their proprietary RI ratings tool helps managers and analysts gain insights into a company's leadership, governance, culture and operational standards of practice, with a focus on issues that are material to its long-term performance.

Their approach includes understanding linkages between sustainability opportunities on the one hand, and growth and competitive advantages on the other. Columbia Threadneedle also seeks to analyse the quality of operating practices and potential controversies in light of ESG factors, as an input to mitigate risks.

Does having a responsible or integrated investment approach improve or reduce the prospects for returns?

We cannot predict returns, but there are several reasons why an integrated approach can help company performance and to better position the investors within the market. Some examples of these are as follows:

- When the management of a company is aware of ESG factors and takes them into account in their decision-making process, it is a clear signal of long-term thinking.

This awareness can have a direct impact on the P&L of a company. Management can increase their readiness for items such as carbon taxes (on the environmental side), while class actions or fines against the company may be less likely (on the social side). A more robust governance style introduces more checks and balances and improves the stewardship of investor capital, reducing the likelihood of events that put management interest ahead of investors', such as the so-called "pet projects" or "empire building".

- Whereas exclusion may be needed for some sectors that are unequivocally unethical – e.g. land mines – we think there are both economic and societal benefits to a more nuanced integrated, relative approach:
 - An integrated approach – which looks at the different aspects of a company relative to its sector – introduces incentives to company management to be more ESG-friendly than a blanket exclusion. In this sense, companies can perceive an improvement in their cost of capital as more investors invest in their companies alongside their improvement in ESG practices. If many investors shun one sector, there is no incentive for the companies within it to improve their practices as there would be no gain in leading the pack.
 - Similarly, we should be aware that blanket exclusions can put money in the pockets of less scrupulous investors. If a company faces customers who are insensitive to product price, they will be able to pass on the higher cost of capital of an exclusion in the form of higher product prices. By applying the blanket exclusion, ESG-aware investors may be transferring money from the pockets of the company's customers to those less scrupulous investors. A more nuanced approach can help break this vicious circle.
 - When looking at a company, an analyst must look both at the introduction of practices that have a direct impact on ESG terms – like appointing more independent directors for better governance – and practices based on 'adaptation', which refers to the ability of a company to react to circumstances directly linked to ESG issues (e.g. protecting or disposing of properties sensitive to rising sea levels), or the legal and regulatory changes they may bring about (e.g. tackle the CO2 emissions to reduce the potential impact of carbon taxes).

How are you overseeing the ESG aspects of Horizon's current investments?

We currently monitor the ESG MSCI ratings for securities held in the portfolios on a monthly basis, and how the distribution of these evolves over time. MSCI ESG ratings go from AAA to CCC and you can find more information on MSCI's website: <https://www.msci.com/our-solutions/esg-investing/esg-ratings>.

We expect to add further portfolio indicators to our review in the coming months, including the Columbia Threadneedle RI Rating and Carbon Foot Print.

Why do you think an integrated approach is preferable to an exclusion-based one?

An integrated approach allows investors to take account of a firm's progress towards a more ESG-friendly modus operandi, and to a certain extent reward, or at least recognise, the path that an organisation is taking. An exclusion-based approach does not allow for any such judgement, and a reduced pool of investors is likely to increase the cost of borrowing for the firm, a cost which may well be transferred to consumers. We believe an integrated investment approach provides more opportunity to positively influence the development of a more sustainable and environmentally friendly world.

Do the Horizon Multi-Asset Funds exclude investments for ESG reasons?

The Horizon approach is to integrate ESG factors in its analysis decision-making rather than always excluding certain investments. However, controversial weapons manufacturers are always excluded from the Horizon funds. Columbia Threadneedle actively screens companies for evidence of corporate involvement in controversial weapons (such as anti-personnel mines or biochemical weapons). Where a company is shown to undertake such activities, it is their policy not to invest in the securities issued by that company.

Could you give a few stock examples on how ESG analysis is applied in Horizon?

Within Columbia Threadneedle's integrated approach, ESG is factored into the investment process as part of its fundamental research.

Johnson Matthey, a UK specialty chemicals company, was recently reviewed. Environmental factors were a key consideration – the company is a pioneer in clean technologies such as hydrogen fuel cells and catalytic converters, and is therefore well-placed to potentially benefit from global structural drivers, such as global spending on green technologies. Columbia Threadneedle felt its social and governance attributes were also strong, with a talented workforce and experienced management and board. The ESG analysis complemented its view on the company's financials and valuation and, as a result, Horizon increased its exposure to the company.

When assessing the risk/reward characteristics of oil majors, the impact of their products and future strategic plans plays an important role. Compared to peers, Columbia Threadneedle's research indicated that **Royal Dutch Shell's** carbon reduction targets and commitments to 'greener' capital expenditure appeared conservative. For this reason, during 2020, the position was reduced.

Within the same sector, oil and gas services companies are increasingly looking to apply their expertise to renewables projects to improve efficiency. This was one of the reasons Horizon's holdings of **John Wood Group** was increased.

Compass Group provides food and support services globally. When it received a poor score in the 2019 Corporate Human Rights benchmark, Columbia Threadneedle requested a meeting with the company. It was comforted by the company's management of social risks across its global supply chain and its score in the 2020 benchmark improved¹. More recently, when the company's Chartwells subsidiary was the subject of scrutiny regarding its school meal boxes, it contacted the company to encourage a response and welcomed the corrective measures taken.

Columbia Threadneedle monitors the carbon footprint of our funds and individual companies. One of the highest emitters in terms of intensity (carbon emissions per unit of revenue) is **Linde plc**, an Irish-domiciled industrial gases company.

The company was met to assess its reduction strategy and the investment was maintained, as the company is proactively improving its footprint by doubling its use of renewable energy. Its products will also be important for the energy transition.

¹ Source: CHRB results (www.corporatebenchmark.org)

This all sounds rather complicated – are there any external labels or categorisations for ESG?

Whereas the efforts for a more sustainable world have been there for decades – the UK will this year host the 26th edition of the Conference of the Parties signatories of the United Nations Framework Convention on Climate Change – its application into the investment space has been gradual and there is a way to go in terms of standardization. We feel that over time a few may become market standard:

- MSCI ESG rating for securities (from AAA to CCC);
- Morningstar Sustainability ratings (1 to 5 Globes) for funds;
- EU classifications for funds (which, post-Brexit, may become adapted in some way in the UK)
 - Article 6, which requires disclosure of how sustainability risks are integrated into investment decisions and the possible impact of those risks on returns. The Horizon Multi Asset Funds are likely to fall into this category.
 - Article 8, so-called "light green" funds that are said to promote certain sustainability characteristics.
 - Article 9, so-called "dark green" funds that have sustainability or reduction of carbon emissions as the fund's stated objectives.

The UK Investment Association is expected to announce its ESG sector categorisation in the second half of this year, and Embark Investments is represented in these discussions by our CIO, Peter Toogood.

Does ESG form part of the thinking in the management of the wider Embark Group?

High standards of corporate governance, our corporate purpose, culture and the relationships between the company and our clients have never been more important as we look to forward the Group's goal of providing positive outcomes for our clients and their customers. Our approach is a responsible way of doing business that also seeks to ensure we create an inclusive workplace and have a positive impact on society and the communities in which we operate.

Embark is committed to achieving high standards of corporate governance, integrity, and business ethics and therefore alongside our main Board and the Boards of our subsidiary companies, Embark also operates a number of sub-committees to provide corporate governance-

In 2020, we also launched the Group Corporate Social Responsibility (CSR) Committee to ensure that responsible investing and our environmental, social and people practices are central considerations in the management and activities of the Embark Group. Our CSR agenda, underpinned by our strong governance structure, covers four key areas:

Responsible Investing

Embark Investments Limited is committed to responsible investing. We practise responsible investment by ensuring that the analysis of ESG factors is included in the investment process of the five Horizon funds.

Environmental Impact

Embark Group has several initiatives underway to reduce its environmental impact regarding energy and waste reduction; including the encouragement of ongoing recycling, travel reduction and the use of raw materials from sustainable or renewable sources. We actively work with our supply chain to look at the traceability of the materials we use and review COSHH (Control of Substances Hazardous to Health) information to ensure that products deployed meet environmental requirements.

Social Impact

As a responsible business we feel it is important to have a positive effect on society and the communities in which we operate, and we are proud to be involved in a number of charitable and community initiatives. We also love to recognise

the wonderful things our staff do for their communities. We ask our employees to nominate those who they feel go 'above and beyond', both in their jobs and in their own time, whether by volunteering, fundraising, taking on community projects, or simply helping others.

Everyone who contributes to charitable organisations and their community is a huge source of inspiration that personifies our commitment to building a better society.

People Practices

We understand that it's people who make places, which is why we strive to engage with our clients and staff using clear communications and understanding things from their perspective.

<https://embarkgroup.co.uk/corporate-social-responsibility/>