THE PRINCIPLES FOR RESPONSIBLE INVESTMENT PODCAST TRANSCRIPT

ESG LEADERSHIP IN LISTED EQUITY EPISODE 2

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Michal Bartek

Welcome to the PRI podcast. In this episode on listed equities, we'll talk to someone who's more experienced than most, and we will reflect on his experiences and observations about responsible investing and what it takes to show leadership in this space. This podcast is part of a series on listed equity in which we explore a wide range of topics and how the industry can continue to challenge investee businesses and provide products clients really want. My name is Michael Bartek and I work as senior lead in equities, it is part of the team that develops content for signatories to help them integrate ESG into their investment process.

Our guest today is Peter Michaelis. He's among the most experienced, successful, and best-known individuals in the responsible investment space. Having spent two decades managing sustainable portfolios, most recently at Liontrust. So, Peter, with all your vast experience, if we were to turn back time and give her to view the current state of responsible investing through the eyes of a 20 years younger, Peter Michaelis what would we see?

Peter Michaelis

I think I would, firstly, I think be amazed at the growth and acceptance of sustainable investment and responsible investment that we've seen particularly over the last five years. Back in 2001, sustainable investment was viewed as a dust, an oddity. Many people were actively hostile to the idea that there was any point or relevance in caring about the nature of the businesses that people invested in. You know, we were deemed to be tree-huggers that just served a particular niche of peculiar people and investors that wanted a sustainable investment outcome. So, I think that's amazingly positive, and I think the, the rise in awareness and consciousness within the investment community of sustainability issues, whether it's carbon emissions, whether it's equality, diversity, biodiversity, you know, that the fact that that has risen to be a relevant part of investment and finance and the language of business.

I think it's been a phenomenal success and a success of really would have surprised my past self. On the other side though, I think it's absolutely sad to say that having kind of studied sustainable development as my doctorate and, and all the movement, there was a foot in terms of climate change with you know, the UN Kyoto protocols, you know, all the knowledge that we have as humanity in terms of the impact biodiversity and the rate of extinction, I would be hugely or quite how to use the tenses, but I would be hugely disappointed by the lack of progress. The fact we haven't deviated actually from any of the trends that were in place. If you look at the world as a whole. So, you know, coal production in China has risen nearly threefold in, in the last 20 years.

The CO_2 in the atmosphere has gone up another 15%. If you look since 1990, so it's slightly longer than 30 years and 10% of the Amazon rainforest has disappeared. And there's been precious little change to the way in which we kind of deliver food. So, the agricultural system. So, I think that's kind of hugely disappointing. Actually, if you look at the last 10 years given, we know what we know given the amount of capital is now available, or, or we can discuss that supposedly available to back sustainable businesses. The, the, uh, you know, the trend is yet to budge in favour of sustainable development particularly in those areas, I'd say equality within societies, carbon emissions and biodiversity.

Michal Bartek

Thank you, Peter, you've highlighted that many of the negative long-term trends in environmental and social space remain. Why do you think that is, who in your view is to blame?

Peter Michaelis

If you look back over decades and centuries that there is a clear trend within our economy to move to a kind of cleaner, healthier sector future. So, you can look at improvements in resource efficiency. I mean, they are the scale of improvement in the management of data and information. It sort of goes in line with Moore's law. For instance, say you've had hundreds of thousand times improvement in efficiency there. If you look at healthcare and the improvement in child mortality, or the statistics in the 20th century - one in five children would make it to their fifth birthday. Now that's more like, you know, one in 300, um, so phenomenal improvements in health. We also find ways to make our societies more resilient and safer. So, you know, you can just look at road deaths per kilometre, driven and fallen, and you factor 50, over the last 50 years. So, you know, phenomenal improvement and where we've seen success, it's always come from a combination of understanding.

So science and understanding - society becoming aware of an issue, governments acting to set the framework and then businesses doing what they do best which is to distribute and develop and scale up the solutions which then deliver the better outcome. So that's kind of my picture of how we progress. As human beings in society on the issues that are sort of spoken about where we haven't seen any progress. I think the key problem is that there isn't that framework, the one thing all these things have in common is that inequality, carbon emissions and biodiversity loss have effectively zero value. I know there are pockets where we have some sort of a carbon price, but in fact, you're down to zero value. So they don't, they don't play in the game at all. And so there's no solution to solve for businesses generally and society.

So, I think that is something of this clearly missing. I think having a kind of framework where becomes a playing field, where everyone can work to find the solution. So, we all agree. The understanding is that the science and understanding is absolutely crystal clear. And the bizarre thing is many of the technological solutions for that. And while they might look as if they cost a lot today, we understand how these things work and the actual eventual cost would be very limited. I think there's also an aspect. And then this, I think comes to sustainable investment as well, whereas individuals we'd been sort of promised in a way that nothing needs to change, we can continue absolutely our levels and patterns of consumption, you know, the way we operate with no constraints at all.

And I think that is a lie, I think there needs to be a bit of honesty brought to the whole debate. We say, you know, things need to change. Yeah, sustainable investment - you know, what we have to do is do things differently. The one thing that I think sustainable investment should always be, is slightly uncomfortable for the people who you know, the practitioners within sustainable investment, because we're, we're asking investors to back something innovative. We're asking companies to do something different where we're sort of meant to be pushing the boundaries. I guess it's, it's quite a long way of saying that for things to change, there needs to be change. Now we believe actually a sustainable economy and the standard society is actually a much better society.

It's one which is much more equitable. It's one, which is less prone to ecological collapse. You have more stable climates. All of these things are, I think aspirational that everyone can agree on. And it's certainly not impossible to solve the problems that we have. It's just, we've got to move away from the thinking that, you know, the world of tomorrow has to be exactly like the world of today. So those are my thoughts around why we haven't seen more change. And you know, I think sustainable investment can play its part. Sustainable investments certainly can't be successful unless governments and society and the rules of the game develop as well.

Michal Bartek

Thank you, Peter. So, let's go forward in time, say 10 years. And let's imagine that Peter Michaelis is now 10 years older and looking back at the decade, starting in 2021, what would he most likely see?

Peter Michaelis

I think ESG and sustainable investing has to prove itself. It has to show that it has played its part in enabling a transition. And so, if you think a decade from now the targets rule of thumb for sort of two degree world are halving of emissions, absolute emissions. So, for sustainable investing to have a point and a purpose, it should have played its part in that. And the scale is huge. We have to move away from an energy system to providing 80% of our energy needs and make no mistake. Modern societies depend on available energy. So, we can't find, and we can't manage without energy. So that inquires an enormous amount of capital being diverted from current destination which is fossil fuel companies to the substitute technologies.

I'd like to see. I think also it should have played a part in moving the model of the terrible word in economics, but consumers consumption, moving out model from consumption of physical goods to sort of, I guess, services that drive improved wellbeing from individuals, because they can have a much lower impact on environment and a negative impact on society as well. I think that should be something that's part of the overall transition. And I think, again, the stem investments should have played its part in helping to shape some of the policy developments. I'm not trying to underplay the importance of sustainable investing. I remember back in 1990 when I was looking at the kind of role of shareholders - shareholders are actually being used as an excuse by management of businesses, not to take action.

So, I think it was ICI back in the time when there would be asked to close the pipes that pumped out pollution into the Irish Sea, and they basically response was we would love to do something to fix these, uh, to put technology on, to adopt these pipes, doing that. But our shareholders wouldn't stand for it. I might have the details of the story absolutely arrived, but that was the kind of thing that shareholders couldn't stand for it now that's totally reversed. And actually, shareholders are the ones who are pushing to change from saying, you know, you have to look 10 years down the line and be a successful business in 10 years' time. So that has changed, but now we actually need to see progress from sustainable investors, in sort of driving that change that we want to see.

Michal Bartek

So, Peter, what do you think is going to happen or what are we likely to see in the area of reporting - reporting by fund managers, to their clients, to asset owners?

Peter Michaelis

I think what sustainable investment and responsible investment have in common across the whole spectrum from sort of ESG integration and engagement all the way through to impact. What they have in common is that clients care about, naturally they care about the returns they make on their investments. But they also care about how they're generating those returns. So, the nature of the businesses that they're invested in. And, and so, you know, reporting needs to honestly, explain to clients what the businesses they're investing in are doing. You know, we're a service industry. So at the end of the day, you know, people will invest in our funds because we're offering them something that they either don't have the expertise about the time to do themselves. And in our proposition is sustainable future funds, we say where we're aiming to deliver strong returns by investing in sustainable companies.

For me, that means that we have to obviously show them the returns they generate, but we also have to say, okay, how do we define sustainable companies? What, what are the positive aspects of sustainable companies that we are putting you into? And to be as transparent as possible in doing that? Now when I look at some of the developments in reporting, I have a background in science, and it makes me very uneasy. Some of the claims that are being made around the sustainability of portfolios, where it's sort of made out that potentially, you know, if you shift your portfolio to a sustainable investment, it will do more to cut your carbon emissions than any action you could take as an individual in insulating your house and driving less whatever.

And I think that is totally wrong. And it brings the sort of industry into distributed because it's more complicated than that. If you shift your pension to a sustainable investment approach, it's not a bad thing, but the atmosphere itself on day one, when you do that, the atmosphere itself sees no difference in terms of carbon being emitted into it. It's a sort of more subtle impact where you are investing and maybe providing capital to companies with lower carbon impact. And so that has a fact much like changing your buying habits. It provides a signal, that is that's positive, but it's certainly not positive to the degree that some actors are claiming. So I think reporting is the honest, she needs to be transparent and needs to explain exactly to clients what they're getting.

Because actually there's no need to overclaim because for most investors, individuals and institutions. You can explain the kind of concept of sustainable investment is such compelling story.

You can use your capital to deliver decent returns. And the evidence has shown that that is what should, what has been achieved certainly so far. And you can be backing businesses that are helping to make the world cleaner, healthier, and safer. That's a very compelling story. We don't need to start over claiming massively. Equally on the other side, the sort of simple labeling relabeling funds, maybe with a tiny little sort of skew in terms of what they do. So saying, this is my responsible investment - that I think equally runs the risk of people looking at eventually and looking at the holdings underneath it and saying, hang on that doesn't look right or smell right, it comes with the holdings that are in that portfolio. So that's what I, where I think reporting has to develop to is so that anyone investing in an asset manage the portfolios can just, you know, kind of click through and see exactly what companies they're holding, why they fit with a particular definition of sustainable sustainability, the base asset managers are using. And then as an industry, we are fulfilling our obligations to clients,

Michal Bartek

Given that a lot has changed in the way men listed companies disclose and explain their approach to sustainability. They've sent themselves transition targets, and they use a range of metrics to explain their progress towards those targets. Has that made the investments pays more competitive for you?

Peter Michaelis

I mean, yeah, it's great that there's more information around. When I first started analysing in 1999, I was analysing companies within the footsie hundred and know maybe half a dozen, a dozen companies that even produced an environmental report. So, the fact that companies are now, you know, listed companies in particular, are you know, declaring a lot more information around carbon around workforce, relationship with suppliers, relationships with clients - that's all to the good. The information is way less consistent than obviously accounting information. So, there's a huge degree of interpretation that is needed and analysis as needed to come to a conclusion in terms of how well the company is running and digging behind kind of glossy sustainability report to work out how well the business is being run.

I think some of those to be welcomed, I mean, as an example, we've been over the last year and a bit and slightly disrupted with the pandemic, lockdowns - we've been engaging with the companies that we invest to see how well prepared they are to transition to a one and a half degree world.

And, so I see three questions. First is do you recognise that in couple of decades, three decades, you will have to operate in a zero carbon world? What is your strategy for getting that and what is your trajectory? And, you know, what are your targets say for 2030, which is probably just about approaching me a timeframe that CEOs and chairman of companies will be thinking. I think one of the first things come out of that is there's many companies were still sort of using the idea of carbon intensity.

It's just saying, yeah, we're going to reduce our carbon intensity by 7%, 5% every year, but we still want to grow our business by 5% every year. So we sort of, I should know the atmosphere doesn't care about intensity. The atmosphere cares about absolute emissions. So, if you want to be a leader in the space, you have to be reducing the absolute emissions. So, I think that it was sort of a challenge for many companies. I think also the kind of long-term planning and, and the dependency of each business on other accidents, whether it's suppliers, whether it's electricity generators - there's also something that that sort of was highlighted and then the complexity of it. But the generally, you know, we feel the businesses are the businesses where investing and buying lodge are putting themselves in a position where suddenly they, they could get to a much lower level of carbon emissions.

So, that I think is, is an improvement in terms of reporting. I don't think they will ever be. And I know that there's kind of this constant debate about, you know, the sustainability ratings companies and the, the lack of correlation between the outcomes, I think that's such a nonsensical debate because what's important is the information underlying it. It's taking that information and turning it into something useful information that's useful from an investment point of view, or this is useful from assessing the environmental and social impacts of a business.

Michal Bartek

Peter it's often said that industry needs to gain a much more longer-term focus. The criticism is that there's too much short-termism in investing in general and in responsible investing too. What do you believe can drive or is likely to drive that change of focus from short-termism to longer term returns and longer-term outcomes?

Peter Michaelis

It's a very good question because it's clearly the trajectory to a sustainable economy is something we're thinking in decades. That’s the themes that we invest behind will play over the next few decades. That's how we're thinking. When we, when we look at businesses, in our investment price, we're always thinking out some explicitly in terms of what they can well, the business can do well. They're looking out sort of on a five-year timeframe. We know in case, we can always be wrong because the future is sort of an uncertain place, but that gives us the context to make an investment decision in some way to measure, our investment thesis against. So, we serve and build in that kind of long term thinking into our investment selection and that sort of plays out as well in the holding periods, uh, of companies within our, within our portfolios.

Typically turnover portfolio is around less than 20% level. Now, I think we always feel that's to our advantage. We have very little idea of what a stock is going to do over the next month, three months. You know, the longer your timeframe, we believe in thinking more conviction you can have in your investment idea. So, the sort of the short-term noise or something that we try to ignore as far as possible now that and this is what I can come back to that can sometimes be uncomfortable. You can sometimes be in stocks, which don't perform well, but you, nevertheless, you maintain your investment pieces and you add to it. So that degree, when that works, you know, really feels like as, your friend, because it gives you opportunities to invest in companies and prices that otherwise you wouldn't get.

I think low-income is really important and it certainly suits actively managed sustainable investment approaches extremely well. I don't know how you drive out kind of short term and holding periods generally of shares is continued to shorten. I would hope that in time and investors see, the short-termism and churn doesn't really achieve either your financial goals or the goals around sustainable outcomes from the businesses you're backing because it encourages the wrong behaviors.

Michal Bartek

Thinking more broadly about the leadership in the listed equities field, what would be your advice to an asset management company that is aspiring to be as good as the leaders in investing the responsible investment.

Peter Michaelis

In a way it's exactly the same as if you want to develop an expertise in any other field in investment. You have to put you know, the right resource behind it. So, you need to find people with the expertise and in this case they will be expertise, both in investment, and in the sort of understanding of environmental and societal issues or expertise in sustainability. You need to back them, you need to develop a strategy which really has sustainability in its core. You need to have, I guess, the courage to get through those uncomfortable periods when maybe the strategy won't be performing, or maybe it's creating, you know, you feel it could be creating reputational risk. We've certainly had events like that in our history, the history of our team where, you know, we've ruffled feathers, where, I mean, I'll give you an example.

There was an oil major in the UK, which was going to invest in tar sands. And we were meant to have a say in terms of the voting process. And we felt that investing in tar sands was terrible, both from a financial perspective and from a obviously an environmental perspective. And so, this certain CIO, you know, we should be voting against this. It was actually sort of voted down. And part of the reason was it would make the meeting with management uncomfortable, you know, literally. And so, I think it has to be big, the courage that if you're going to be doing something different in sustainable investment than you need to be prepared to back. The differences that comes along with that, I guess my third recommendation would be transparency and integrity. It's an area where there's no doubt there is overclaiming going on, in order to make kind of a big marketing splash, but in the end, we all know that it's a quality of the product and the quality of the service to clients - that is what delivers success. So those would be my, my points as to anyone embarking in some new entrance a sustainable investment.

Michal Bartek

Thank you very much, Peter, for your thoughts and for your answers. Thanks for providing us with this fascinating insight into the industry, some of the developments and challenges to watch out for. If you enjoyed this episode, then please do subscribe and rate our podcast and tune in or the next one. Thank you. Bye bye.