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ANOTHER CONVERSATION ON ESG WITH A CIO

In my first article, I outlined our philosophy that ESG is fundamental to, and inseparable from, good investing. ESG is fully integrated into our investment process, because it is the right thing to do. We believe that one cannot claim to be a good fiduciary, mandated to create and preserve long-term wealth, while ignoring the principles of sustainable and responsible investing.

So far, so good. The previous paragraph sounds just like most ESG pages adorning asset managers' web pages and glossy literature. Is there any differentiation in Nikko AM's efforts towards ESG compared with other asset managers? This article will help identify and explain why our distinctive approach to active management matters.

We don't have a global head of sustainable investing who has overall responsibility for ESG implementation.

Many firms have a dedicated team of ESG specialists to research and spearhead ESG activities. We don't believe that ESG activities should be separated from investment activities. At Nikko AM, ESG responsibility resides with the entire investment staff. As the CIO, I have global responsibility over investment *and* ESG implementation. Each investment team head is also the head of sustainable investing, with responsibility for ESG implementation in their investment process.

An analogy would be the decades-old question of 'who runs risk management?' Of course, investment managers run risk management, as risk is inseparable from creating investment returns. The risk management team facilitates risk oversight and provides independent fresh perspectives as a check-and-balance, but it does not take away the investment manager's responsibility for managing risk. Similarly, we believe having a separate head of ESG would dilute ESG's centrality in our investment process, when in fact it is a responsibility that should not be delegated away from fund managers.

More importantly, separating the research and implementation of ESG activities from our portfolio management team would further bifurcate "talking up ESG" from "integrating ESG into investing". We care about the latter. We care about how ESG influences the companies we invest in. Our priority is our fund managers' ability to identify, research and debate on these issues. We want *all* our investment professionals – not just a designated ESG specialist – to speak knowledgeably about the nuances inherent in ESG issues.

To ensure that ESG implementation receives a top-down focus as well as bottom-up attention to details, we require each investment head to present their ESG implementation activities to their respective boards. We also mandate that each investment professional undertakes regular ESG training.

Researching ESG issues is always subjective, but a good process must include robust debate of the issues from all angles to help identify their relative relevance to the investment outcome.

There is a growing industry of researching and rating companies using ESG criteria. However, we don't believe ESG can be neatly captured in a rating or a set of quantitative scores. We don't believe complex issues such as climate change, corporate governance and the social consequences of shareholder capitalism can be easily quantified and solved by a computer program or via a quantitative process. While ratings and scores are useful tools, we believe that thorough research, robust debate and direct engagement with companies to get a first-hand appreciation of the issues, are still the best way to size up ESG and judge its impact on an investment outcome.

Our investment teams debate relevant ESG issues as part of their company research. This is no different from debating the competitive edge and sustainability of company business models, and the quality of their management team. There are always research providers who claim that they have discovered the best system to differentiate a good ESG company from a bad one. But we don't believe an organization's commitment to do the right thing can be so easily captured by a rating.

We do subscribe to independent research providers' ESG ratings as a check-and-balance to challenge our own research. We utilize external research reports to highlight companies in the high-risk ESG category. This serves as a catalyst for more in-depth debate on such holdings within the team, as well as a broader audience through our ESG Steering Committee.

We don't apply an exclusion list as an ESG tool, unless a client instructs us to.

The exclusion of a market segment must be driven by a client because of their desire to achieve a certain impact on society or express an investment philosophy. We are very supportive of such socially impactful investing themes and have managed a wide variety of them.

Conversely, a blanket exclusion of an entire industry may conflict with achieving the best returns for the client. This is not to say that being socially responsible contradicts being a good investor. On the contrary, we believe both objectives are compatible and mutually reinforcing. The problem lies in the outright exclusion of certain market segments based on a formulaic filter, which may be narrowly based, myopically focused and inflexible. We believe that an ESG integrated investment process that asks all the tough questions about the long-term sustainability of a company, combined with active engagement with the management team, will lead to the best outcome without taking away flexibility from the fund manager. Constraining the investment universe may lead to a sub-optimal outcome. It is imperative that clients appreciate the potential impact of applying negative screens, as part of their due diligence duties to their beneficiaries.

Even if achieving a social impact is not an explicit goal of the client, we believe there are many effective channels for an investment manager to influence positive changes and be socially responsible while fulfilling our primary duties as a fiduciary. These include direct engagement, proxy voting, and speaking up on the importance of ESG.

We see ourselves as long-term active investors and at the same time, socially responsible.

First and foremost, we are active, long-term investors with a primary duty to create and preserve wealth for our clients. The famous quote by Milton Friedman stating that the social responsibility of business is to increase its profits is often misinterpreted as the duality between profit creation and social responsibility. It doesn't have to be one or the other, as he further explains: "only people can have responsibilities."

Our philosophy runs along the same line. Our fund managers are not a group of return-maximizing automatons. We are people with a social conscience and well aware of the capital's impact on broader challenges facing our society. For that reason, our ESG implementation starts with and centres on each fund manager as a person, to ensure they can see all angles of a complex issue, weighing all the factors, to make the best assessment on each business to invest in.

A good long-term investor has to focus on the sustainability of a business, in which ESG factors influence the outcome as much as financial factors. A good capitalist with a long investment horizon has to be a socially responsible one.

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