BEUTEL GOODMAN FIRESIDE CHAT SERIES

Integrating ESG: Fireside Chat with Eva Grant

Responsible investing is becoming increasingly important for both asset managers and investors. ESG-branded mutual funds continue to see record inflows, according to a recent report from EY which describes ESG as "a fundamental change in investment." We recently sat down with Eva Grant, Vice President of Portfolio Analytics and Responsible Investing to discuss how ESG is being integrated into the investment process at Beutel Goodman.

The recording took place on May 14, 2021. The following transcript has been edited for clarity.

Matt Padanyi : Thanks for joining us. My name is Matt Padanyi. I am the content and communications manager for Beutel Goodman and today I am speaking with Eva Grant, Vice President of Portfolio Analytics and Responsible Investing. She's one of our in-house experts on ESG, which is the subject of our discussion today. Eva, thank you for taking your time to have this chat.

Eva Grant : My pleasure Matt. Glad to be here.

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MP : Without a doubt, ESG is an increasingly popular and important topic in the world of investing at large. We see it in the media, [in] analyst reports, white papers and [as]the headline subject of many industry events. Of course, [ESG] stands for environmental, social and governance – the three main areas of focus behind the concept. But what strikes me as an observer is the lack of clarity, I call it, about the topic. For example, a recent survey I came across from Bank of Montreal's global asset management unit shows about two-thirds of investors are aware of ESG, but one-third of that group say they're not even sure if their own holdings are ESG friendly. I think there's confusion over the terminology. Let's start with how are we defining ESG here at Beutel Goodman?

EG : There are several ways of looking at environmental, social and governance, or ESG, issues and how these factors are integrated into an investment process. At Beutel Goodman, we practice ESG integration, meaning that we incorporate ESG considerations into our bottom-up, stock-specific research. We consider governance issues such as capital allocation decisions, executive compensation and succession planning, environmental issues such as climate change and emissions targets, as well as social issues, including company responses to the COVID pandemic, employee safety and leadership and workforce diversity.

We favour an approach that incorporates diligent stewardship to influence positive change by having a seat at the table. We do this by exercising our voting rights and through ongoing engagement with board members and management [teams] of our portfolio companies.

ESG integration differs from socially responsible investing, or SRI, which typically involves exclusionary values-based screens — for example, against alcohol or fossil fuel investments. ESG integration is also distinct from impact investing, [which] has the primary goal of creating positive impact.

We are dedicated to generating superior long-term returns for our clients with a focus on capital preservation, absolute risk reduction and downside protection in declining markets. ESG factors have the potential to materially affect the long-term sustainability of a business and are thus an important part of our analytical process.

MP : OK, that's great. So, we've defined it, now let's talk more about the approach. How exactly does ESG fit into the overall value-investing process here?

EG : Beutel Goodman is a value investment manager with a long-term investment horizon where preservation of capital is paramount. As value investors, we have always focused on risk and any risk factor that could impact investment valuation is considered in our research. We manage concentrated portfolios of our highest-conviction ideas and firmly believe our analysts or portfolio managers, as experts in their portfolio companies, are best placed to assess ESG-related risks and opportunities.

Each analyst builds a financial model comprising [of] forecast financial statements and [the] identification of financially material risks, including ESG risks. This information is then used to determine several valuation metrics to substantiate an intrinsic value for the company. As value investors, we search for quality companies trading at a minimum one-third discount to our estimate of intrinsic value.

Quality to us is a business with strong position in its industry, a good balance sheet that generates steady and growing free cash flow which results in increasing business value over time. We also look for capable management teams with appropriate incentives in place that allocate capital in the best interest of shareholders and with sound ESG practices. We thoroughly review corporate governance and assess the long-term sustainability of businesses, focusing on cash flows and any financially material risks that could impact those cashflows.

We approach share ownership as an ongoing collaboration in the creation of long-term shareholder value. In my role, I provide additional overlay and we also have an ESG working group that discusses ongoing and future initiatives. Our management committee provides oversight for all of our ESG practices.

MP : Alright, so you've mentioned the materiality aspect. What are some notable examples of how ESG issues have developed into tangible material risks?

EG : Consistent with our long-established investment process, Beutel Goodman will not make any investments where ESG or other risk factors make it difficult, if not impossible, to accurately assess the valuation of a specific business. For example, we considered Parkland [Fuel Corporation], a Canadian independent distributor and marketer of fuel and petroleum products as a potential new edition to our portfolio. However, we decided the uncertainty and risks linked to the company's business model and broader commercial ecosystem made it difficult to value the business accurately and decided not to continue our research.

Another example of how ESG issues are increasingly intertwined with future financial performance is Bayer [AG]. An initial governance issue with the company that also led to environmental issues factored into our decision to exit the stock. Specifically, we viewed the acquisition of [The Monsanto Company] as a major transfer of wealth from Bayer shareholders to Monsanto shareholders, no matter how well the acquisition was integrated and no matter what level of synergies.

In addition, Bayer did not just buy Monsanto, they also acquired the Monsanto Roundup litigation, where Monsanto is being sued in a class action for a link between use of the weed killer and cancer. We determined we could not appropriately value the additional open-ended risk. We had multiple meetings with management about the agreement and outstanding liabilities and ultimately exited the investment.

MP : Alright, so it actually really sounds like a thorough process. ESG is often discussed as a risk but you've said to me before in conversations that we've had that it also represents an opportunity. I think that's really novel. Can you explain exactly how it can be an opportunity?

EG : Sure! As an example of the various potential opportunities, many companies are positioned to benefit from the transition to a lower-carbon future. For instance, although natural gas infrastructure will face pressure from the low-carbon transition, it is more insulated due to its demand drivers, such as home heating, and its relative emissions cost profile in areas like power generation.

Our holding, TC Energy [Corporation], in our view, has assets which are well positioned to manage through the energy transition. In the future, natural gas pipelines can play a key role, given that existing pipe in the ground can handle a hydrogen mix in the gas stream. TC Energy is also looking to expand renewable resources for internal needs and has opportunities such as pumped storage. Another example is the use of renewables for their compressor fleet, which is about 5% electrified.

There are similar kinds of opportunities on the manufacturing side, too. Our U.S. holding, Wabtec [Corporation], manufactures equipment and systems for rail. In early 2021, the company announced the world's first battery-electric locomotive using regenerative breaking, a significant step forward for the rail industry. The company is playing a critical role in decarbonizing freight rail and reducing global emissions related to transportation.

Our holding, Michelin, a France-based tire company, has made several steps forward to gain from the energy transition. The company has set up a joint venture in Chile to build a facility which will take end-of-life mining tires and break them down to be used as primary material. It also has another technology partnership where it will trial taking difficult-to-recycle plastic waste and converting it into a plastic that can be used to reduce the use of synthetic rubber in tires.

Further, Michelin has a leadership position in tires used in electric vehicles with market share of about 1.5x the market share it has in tires for traditional cars. The company expects electric vehicles to massively outgrow internal-combustion engine vehicles, which would allow for faster growth and higher margins. Michelin has also set a goal which is to make all of its products using only bio-sourced renewable or recycled material by 2050 — quite a goal when you consider that, today, most of the inputs to make its products are virgin material.

MP : Quite a goal indeed! But that's one of the things I love about this discussion — it's all about ambition. Can you talk to us about your active ownership efforts and what other initiatives are in place to communicate and promote ESG or responsible investing?

EG : Matt, active ownership for us is about communicating with our holdings companies. In our view, both engagement and proxy voting are effective mechanisms to mitigate risk, increase returns and advance shareholder value. We have long advocated for sound corporate governance, which we believe is the foundation of the responsible management of the company's environmental and social practices. We have adapted our ESG research engagement to include relatively newer themes, such as climate change and resource management.

Our strong preference is to interact with the board of directors and senior management, though we also welcome engagement with other executives, including specialist responsible investment or sustainability department heads. This interaction provides important insights into companies and ESG factors, and how these may impact long-term shareholder value.

Our engagements regularly cover governance-related issues, such as capital allocation, including acquisitions, share buybacks and dividends, strategy, board composition and executive succession planning. We have also been incorporating themes such as strategies to achieve net-zero emissions and sustainability reporting and disclosure.

Proxy voting is also a very important part of our active ownership practices. We believe it can encourage sound corporate governance and improve environmental and social policies. We assess all [relevant] items based on whether they are consistent with long-term shareholder value creation. If necessary, we engage with companies to understand their views more fully. We also consider the recommendations of our proxy-voting service provider, we then former own opinions and vote accordingly. Our votes are posted on our website following the AGM.

To communicate our active ownership practices, we publish an annual responsible investing report, available on our website, as well as make our quarterly responsible investing reports available to our clients. These reports detail our engagements and proxy-voting statistics, as well as company updates regarding all things ESG.

We promote sustainable and responsible financial markets when appropriate. In addition to being a PRI signatory and recognizing the importance achieving the goals of the Paris [climate] agreement, we support the recommendations of the Task Force on Climate-related Financial Disclosures, or TCFD, which was established by the Financial Stability Board to address systemic risk to the global financial system posed by climate change [Ed. note: the Principles of Responsible Investing is a United Nations-supported network of investors working to promote sustainability. Signatories agree to commit to the principles.].

We encourage all companies in our portfolios to provide disclosure of climate-related risk that is aligned with the TCFD recommendations. We are members of the Portfolio Management Association of Canada, which maintains recommended guidelines on principles for governance of public companies. We also regularly participate in collaborative industry efforts.

MP : OK, so what happens if [management teams you're engaging with] shut you down or if they ignore your engagement?

EG : We regularly monitor our holdings to identify ESG incidents or controversies that may require reactive engagement. If significant ESG-related concerns are identified, we will engage with the company on multiple occasions over a timeframe that allows for positive change. If we're not satisfied with the company's actions, we escalate the disagreement through proxy voting. Failing both engagement and proxy voting, we may decide to reduce or divest a holding.

MP : I'm gonna change gears a bit on you. ESG is very much a fluid thing — different factors have different impacts within different industries at different times, and so on and so forth. So, what exactly are your engagement priorities?

EG : You know, Matt, material ESG factors vary by industry. For example, flaring of natural gas, a potential material issue in the oil industry, is not material to the telecom industry, where data security is more important, for example.

We've identified a few priority engagement topics to frame engagements, including executive compensation, management succession, climate change and commitment to net-zero, energy transition risks and opportunities, employee safety, diversity and inclusion, and indigenous engagement.

MP : Alright, so it really is a fairly holistic set of priorities, then. What impact has the ESG process had on your portfolios and how do you measure that success?

EG : You know, it's difficult to quantify the attribution effects of ESG factors, given our integrated approach. Companies with strong ESG practices often share many of the sound fundamentals that are attractive to value investors like us — namely, a business whose qualities and management practices generate stable, long-term cash flows.

We believe our integrated ESG approach, which considers material ESG risks and opportunities in the broader context of companies' commercial viability and ecosystem, leads to superior risk-adjusted returns over the long-term. The objective of our research process is to identify high-quality, liquid companies whose managements have successfully built shareholder value over extended periods of time.

We manage risk at the security level, focusing on selecting stocks that we believe will capture a substantial portion of an up market and a lesser portion of a down market. Our goal is to gain as thorough an understanding as possible of the businesses we invest in and to closely monitor all inherent risks in each security that we own in the portfolio.

MP : Alright, I'm looking at my watch and sadly that's all the time we have today. Thank you, Eva, for joining us for this fireside chat.

EG : My pleasure, Matt. I hope that I've covered all the main points in highlighting our ESG integration efforts.

MP : Well, I think you did a very good job of that! For those of you listening in, please do feel free to reach out to your relationship manager to provide us with any feedback or if you have any additional questions. Thank you, again. Have a great day.

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