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LOMBARD ODIER
INVESTMENT MANAGERS

# Integrating Sustainability into Equities

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In doing so, we are able to identify companies where the market is undervaluing their ability to generate sustainable excess economic returns in the future. This, we believe, enables us to capture the most attractive opportunities that will arise from the Sustainability Revolution.

**Pillar 3**
**Sustainability of a company's business model**

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# The Sustainability Revolution

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The next economic revolution is already underway. At Lombard Odier Investment Managers, we believe it will drive returns in the next three to five years and beyond.

Our current economic, social and governance models are unsustainable, in our view. We are facing some significant long-term structural trends, which are already changing aspects of the ecosystem within which companies exist.

## Our operating model simply has to change.

We have to fundamentally rethink our approach to the many established norms, such as transport, food systems, healthcare, education, data management, infrastructure and on and on. No country, sector, company, or asset class will be untouched.

This is the Sustainability Revolution, and, we believe, it is the largest investment driver in history.





## Embedding Sustainability into equity portfolio management

The need for companies to adapt to long-term structural trends is not new. They have been doing it for centuries, and we, at Lombard Odier, have long recognised this basic principle.

As asset managers, we believe it is our job to identify companies that are well positioned for the transition to a more sustainable model. Companies that are able to take advantage of the significant opportunities the Revolution presents are more likely to be those who continue to grow, gain market share, and deliver sustainable excess economic returns for investors.

At the same time, we want to avoid investing in businesses that are not able, or willing, to adapt because, in our view, this could pose an existential threat.

We believe sustainable excess economic returns will be delivered by companies with a combination of sustainable financial models, sustainable business practices and sustainable business models.

We translate this into a three-pillar investment approach, designed to identify which companies are more sustainable over the long-term, and therefore best positioned to navigate this Sustainability Revolution.

| 1 Sustainable **financial models** | 2 Sustainable **business practices** | 3 Sustainable **business models** |
|---|---|---|
| Financial viability with attractive opportunity to generate returns, e.g.:<br>· **Equity:** generate excess economic returns | Focus on the broad stakeholder ecosystem of the business<br>· **Long-term metrics:** ESG, CAR[1], SDG scores<br>· **Short-term metrics:** controversy score<br>· **Impact metrics:** e.g., carbon emissions, water consumption | Ability to take advantage of transformative long-term structural trends<br>Megatrends expressed as transformative themes likely to create significant opportunities for entire sectors<br>Opportunities translated into investment themes, based on sectors impacted |


Source: LOIM.

[1] CAR is LOIM's proprietary ESG scoring framework. SDG refers to UN Sustainable Development Goals.

# Pillar 1 – Sustainability of a company's financial model

The starting point for any investment is the financial strength of the company.

The starting point for any investment is the financial strength of the company. For equities, we look to identify companies with the ability to generate excess economic returns. To do this, we believe they must be capital efficient, cash generative and have a limited dependency on capital markets.

**Excess economic return**

We believe a company that creates an economic value above its cost of capital will grow its equity market valuation over time. This dynamic will be even more rapid if the company can accumulate and compound this creation of economic value by reinvesting in its profitable activities. We call this creation of economic value above the cost of capital "excess economic returns".

Our investment philosophy is anchored in assessing excess economic return because we believe too many companies are spending their way into growth by burning capital and ultimately destroying equity valuation. In our view, growth is sustainable only if it is created by a business model that delivers excess economic returns.

We believe companies that generate the highest level of excess economic return typically will be:

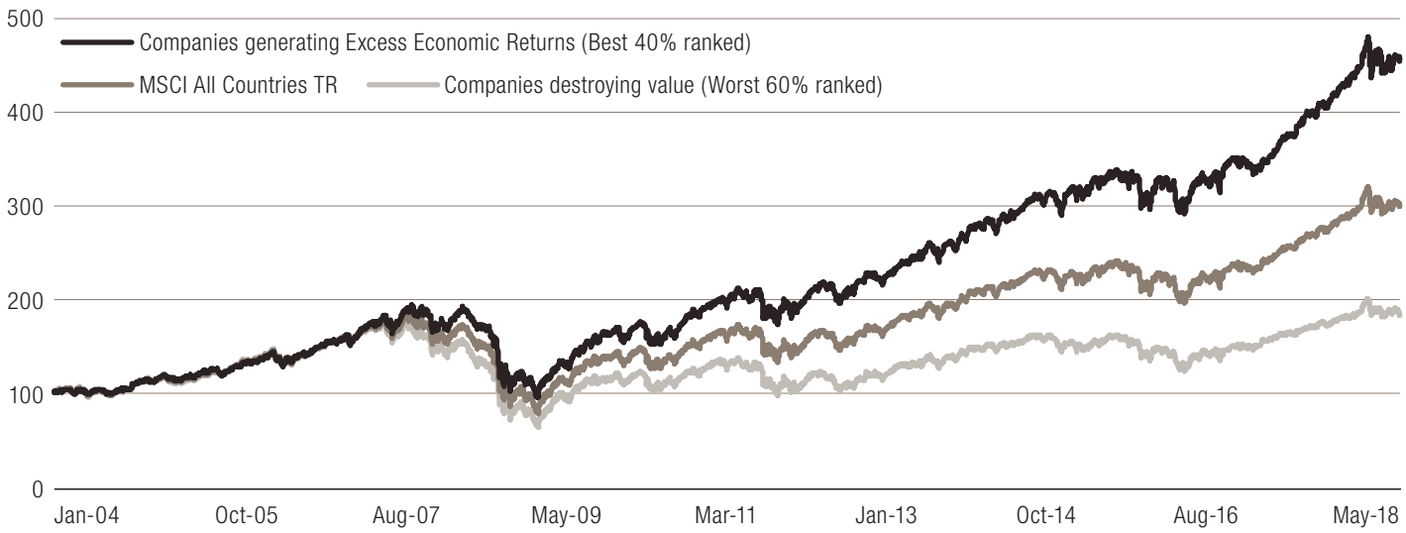
- **Capital efficient:** for every dollar provided (debt and/or equity) it generates the highest amount possible of "new" dollars through its economic activities.
- **Cash-generative:** after having spent the annuity of capital required to maintain its economic asset base (replacement spend), it generates the highest possible cash flow for funding either growth and/or returning capital to financial markets.
- **Limited dependency on capital markets:** we believe companies should run their operations in a manner that does not require constant capital raising and or new sources of debt to balance their books. The risk otherwise is that equity holdings get diluted over time, or face too much risk due to an over-accumulation of debt.

Key to our investment approach is identifying companies whose ability to create excess economic returns is underpriced by the market. It is of the utmost importance that the two are linked together and not analysed in isolation. We have no issue paying a premium for a company as long as it creates a disproportionally higher level of economic returns. For that purpose we focus on multiples of economic capital (Price/Book, EV/Capital employed) which we believe are much more reliable metrics than Price/Earnings. We call that approach discounted excess economic return.

By focusing on these key characteristics using disciplined and specific analytical steps, we can more efficiently define our universe of potential stocks. Once we have established this more focused universe, we can then carry out in-depth, forward-looking fundamental analysis.

Figure 1 on the next page shows how our approach of focusing on companies where the market is underpricing their ability to generate sustainable excess economic can add value to portfolios over time.

**FIG. 1 PERFORMANCE OF THE UNIVERSE OF WORLD EQUITIES** (APPROX. 2,800 STOCKS)




Source: LOIM calculation on the population of companies in the MSCI World AC. For illustrative purposes only. Past performance is not a guarantee of future results.

Methodology: Stocks are classified from best to worst, according to their ranking on our 3 criteria: capital efficiency, maintenance free cash flow yield and external capital dependency.

Methodology varies slightly for Banks but uses the same principles.

Every quarter, stocks' classification is reviewed and each group's performance is tracked. Best-rated stocks (first 4 deciles called «Companies generating excess economic returns») outperform all other stocks (all other deciles called «Companies destroying value»). Best-rated stocks are then split according to their valuation comparing their P/B to ROE. The best-rated companies with the lowest P/B in relation to their ROE are considered as companies with "Discounted excess economic returns."

# Pillar 2 – Sustainability of a company's business practices

The second pillar of our approach to sustainability looks at how businesses behave in relation to their broader ecosystem of stakeholders.

We believe that, for a company to deliver long-term value, it needs to be focused on all its stakeholders, including regulators, shareholders, employees, clients, suppliers, the environment, and its local community. In other words, to be as focused on its business practices as on its financial performance.

In fact, we believe companies that can show strong performance on environmental, social and governance issues will benefit from stronger excess economic returns over the long term.

In our view, analysing business practices is about much more than applying third-party Environmental, Social and Governance (ESG) ratings to our investment process. Our long experience in this space has taught us the importance of collecting, verifying and enhancing large amounts of raw data. Our dedicated sustainability team collects the most granular level of non-financial data from our providers, and compliments this with data gathered from alternative sources. This second aspect is particularly key for the social element of the scoring.

This focus on raw data gives us a better understanding of what that data is actually telling us. By running it through a proprietary model, and using our dialogue with companies to enhance our information, our portfolio managers can benefit from more investment-relevant information to educate and improve their decision making process.

We have several tools to assess the sustainability of a company's business practices:

**Long-term metrics – ESG/CAR scoring**

We use our own methodology to score companies based on 115 distinct, identifiable and credible data points to analyse whether they are aligned with best practice in terms of Environmental, Social and Governance (ESG) matters, and whether they are making progress in transitioning to more sustainable business practices.

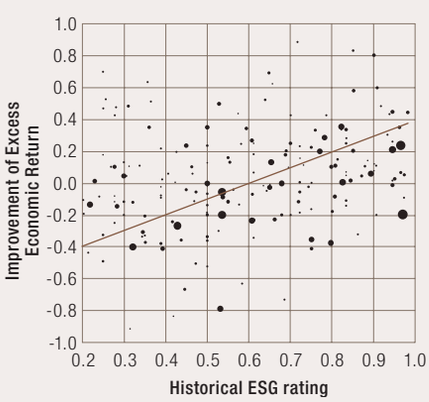
We have developed a proprietary 'CAR' methodology, which helps us differentiate between companies that are talkers, doers or achievers when it comes to sustainability. We believe this methodology, which breaks the ESG data down into Consciousness, Action and Results, is more valuable than relying on external aggregated ratings as it helps identify companies making genuine progress towards more sustainable business practices.

Our portfolio management and research team can then use this non-financial information alongside their financial analysis to assess the investment case of the company. Importantly, they are able to use their regular interactions with companies to modify and update the ESG scoring based on their qualitative judgement. As a result, our portfolio management teams are better able to form an opinion on risks and opportunities associated with the way a company behaves. This also allows for a continuous improvement of our data and scoring as qualitative inputs and/or revised scoring from investment teams is fed back to our sustainability team.

This approach underscores our belief that business practices drive operating performance.

**FIG. 2: THE LINK BETWEEN ESG RATINGS AND EXCESS ECONOMIC RETURNS**

MSCI Europe ex Financials




Source: LOIM.

## ESG ratings drive operational performance

Over the long term, our analysis shows companies that have demonstrated the highest relative level of business practices over the last 6 years have, on average, materially improved their ability to create value (excess economic return) compared to their peers. We believe this positive link demonstrates that, by focusing on best practices, companies can structurally improve their operating performance. And that should ultimately benefit investors.

## Case study: DSM

In our view, DSM illustrates this point. The company offers health, nutrition and materials products.

The company is putting sustainability at the heart of its corporate strategy and is also perceived as an ESG leader compared to its peers. For example, DSM's executive and board members' remuneration is linked to long-term sustainability targets, accounting for 15% of base salary. The company has also implemented its "Brighter Solutions Programme," which helps meet customers' sustainability expectations by identifying solutions with environmental and social benefits.

By 2017, the company had already achieved its 2020 target of reducing its carbon emission per unit of product by 40% compared to 2015. From a social perspective, DSM has also implemented initiatives to promote and retain talents and increase employee engagement.

As the company has progressed along this path to more sustainable business practices, its margins and returns have progressively improved. We expect this trend to continue and, in our view, DSM should benefit from attractive growth thanks to its new, more sustainable solutions.[i, ii]

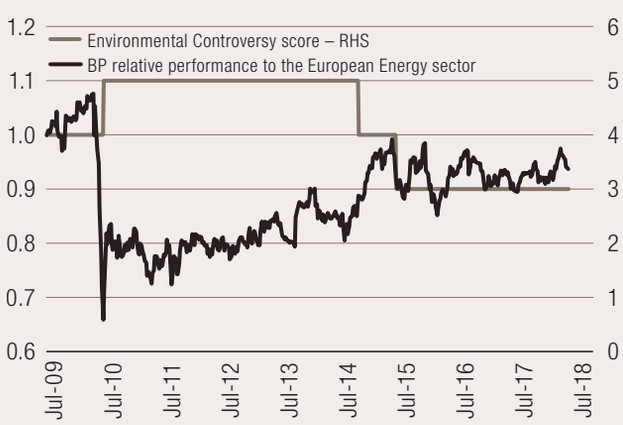
### Short-term metrics – controversies

A company's exposure to controversies in the short term is a strong signal that it is not focused on best business practices over the long term. We therefore look at companies' exposure to controversies, and the severity of those issues, as a means of managing portfolio risk.

## BP: A long road to recovery after Deepwater Horizon

On 20 April 2010, the Macondo Prospect, operated by BP in the Gulf of Mexico, exploded killing 11 people and injuring many of the 126 crew members on the platform. Two days later, a leak was discovered that later became the largest marine oil spill in history. The company's controversy rating jumped from 4 to 5 as a result. US Federal investigators later concluded the event was the result of poor risk management, last-minute changes to plans, failures to observe and respond to critical indicators, inadequate well control response and insufficient training. The impact of the Deepwater Horizon spill on BP's share price has been both significant and lasting. As the chart below shows, once the accident occurred, the share price fell sharply relative to the European Energy Sector. It took several years for the share price to normalise. It was not until September 2014, once the gross negligence ruling was passed, and more clarity was provided to the investment community on the resulting liabilities and improvement in BP procedures, that the share price began to recover and trade on fundamentals.

**FIG. 3 BP'S SHARE PRICE RELATIVE TO EUROPEAN ENERGY SECTOR**




### Impact metrics

We also analyse companies' carbon emissions and water consumption. This helps us assess how companies are trying to reduce their economic risk in a carbon and water constrained economy. In turn, that gives us a better understanding of their resilience to the future path of regulation. If governments take the path of introducing taxes or punitive pricing systems as a method of forcing change, then we believe companies demonstrating better impact metrics should be able to build a competitive advantage and benefit from improved margins versus their peers over the long term.

By integrating these different layers of analysis, we are able to differentiate between companies in the same sector based on the strength of their business practices. It also means we are more able to identify risks and opportunities that may otherwise remain hidden, and better identify companies with poor practices that could expose them to the risk of potentially catastrophic controversies.

Our portfolio managers can use this information as a basis to verify and enhance the quality of our investment analysis. In some cases, it can also highlight areas where we need to engage in dialogue with companies. This is an important aspect of our stewardship efforts, as outlined below.

## Carbon emissions: A rising cost for corporates?

Tackling climate change is an area of growing focus for many governments. We are increasingly seeing attempts to put a price on carbon. In Canada, for example, Prime Minister Justin Trudeau has announced plans to introduce a national carbon price. Under this plan, carbon pollution will cost C$10 per tonne in 2018, rising by C$10 per year until it reaches C$50 in 2022. A report by the World Bank in March 2018 suggests this initiative would raise production costs significantly, adding 5.7% on average for Canadian exporters, but as much as 16% on average for the most vulnerable 10% of those companies. Their analysis shows the impact on different sectors could vary significantly with around a 26% cost increase for petroleum product manufacturers, over 23% increase in water transportation, 12.5% in forestry and 9.4% in diamond mining.

We expect a similar trend to occur for water. This process is essentially the 'pricing' of negative externalities, which governments can use as a tool to change the economic behaviour of companies and consumers.

By measuring impact metrics in an increasingly carbon and water-constrained world, we can better assess two things:

1. How resilient a company is likely to be in the context of regulatory developments
2. The likely impact on the cost structures of companies if that regulatory push is enacted through wide-spread pricing of negative externalities

Both of these considerations help us assess the ability of a company to transition to more sustainable business practices in an orderly fashion.[i, ii]

# Pillar 3 – Sustainability of a company's business model

In addition to looking at a company's financial sustainability and the strength of its business practices, we also look at the sustainability of its business model when subjected to long-term structural trends.

This is not a new phenomenon. Companies have always had to adapt their business models as their operating environment changes. Analysing corporate strategy has therefore always been a key component of investment decisions. The ability of a company to generate economic return is constantly under pressure from their value chain (suppliers and customers) and from risk of competition/substitution or increased regulation. Traditionally corporate strategy is deployed to help protect companies' economic returns by raising lines of defence such as brand power, pricing power, bargaining power, scale effect. It should also be designed to identify and take advantage of opportunities created by the changing business environment. Historically, companies had reasonable time to adapt and were able to evolve unless their legacy asset base was too capital intensive.

However, today we believe the need to adapt is more urgent than ever before because the scale of the sustainability challenges we face, and the speed of change, are unparalleled in our history.

At Lombard Odier Investment Managers, we believe there are five mega trends driving the Sustainability Revolution, which will have a transformative effect on our global economy: Demographics, Climate Change, Natural Resources, the Digital Revolution and Inequality.

Within each of these mega trends, we map out the likely path of future development for a more sustainable outcome in order to better understand which sectors will be impacted, and how. This, in turn, allows us to identify opportunities that can be translated into investment themes and ultimately determine how well or how poorly a company is positioned to navigate the opportunities and challenges ahead.

In the case of Climate Change, for example, politicians and regulators are playing a crucial role in distorting market forces (subsidies, rules) to alter economic actors' behaviours and achieve a more sustainable path. We believe this change in regulation will accelerate and create a sustainability shock across many industries. Positive investment themes include renewables, energy storage, transmission, distribution and efficiency, electric cars and smart transportation. Negative themes would include carbon-rich natural resources, traditional utilities and other carbon-intensive activities.

In the case of the Digital Revolution, innovation lies at the heart of the solutions for many of the sustainability challenges that our society is facing. For a growing population, that is also more urbanised, less equal and dealing with pollution issues, access to basic services is more challenging. For instance, in the Healthcare sector, cost and access are key issues. Some studies put the potential benefits from a more data-driven healthcare system at USD 2-10tr globally (McKinsey 2016). From remote monitoring of patients, wellness programs, better diagnosis and treatment, more efficient usage of existing infrastructure, new medical devices, distribution channels and reduced R&D costs, digitalisation is at the heart of a more sustainable Healthcare system.

To assess the sustainability of the business model of a company in such a fast moving landscape, we enhance our strategic business reviews of companies through the lens of our sustainable trend analysis. With these strategic reviews, we can identify which companies could capture the benefits of implementing successful solutions to sustainability issues. At the same time, we analyse what can constrain or even threaten their business models, and balance that against the line of defences a company's management has put in place through its corporate strategy.

## ExxonMobil: Adapting the business model for greater sustainability

Due to concern over the risks of climate change, a number of countries have adopted, or are considering the adoption of, regulatory frameworks to reduce greenhouse gas emissions. These include adoption of cap and trade regimes, carbon taxes, restrictive permitting, increased efficiency standards, and incentives or mandates for renewable energy. These requirements could make ExxonMobil's products more expensive, lengthen project implementation times, and reduce demand for hydrocarbons, as well as shift hydrocarbon demand towards relatively lower-carbon sources such as natural gas, among others. Current and pending greenhouse gas regulations or policies may also increase ExxonMobil compliance costs, such as for monitoring or sequestering emissions. Many governments are providing tax advantages and other subsidies to support alternative energy sources or are mandating the use of specific fuels or technologies. Governments and others are also promoting research into new technologies to reduce the cost and increase the scalability of alternative energy sources.

ExxonMobil recognises its future results may depend in part on the success of its research efforts and on its ability to adapt and apply the strengths of its current business model to providing the energy products of the future in a cost-competitive manner. This company is conducting its own research both in-house and by working with more than 80 leading universities around the world, including the Massachusetts Institute of Technology, Princeton University, the University of Texas, and Stanford University. Their research projects focus on developing algae-based biofuels, carbon capture and storage, breakthrough energy efficiency processes, advanced energy-saving materials, and other technologies. For example, ExxonMobil is working with Fuel Cell Energy Inc. to explore using carbonate fuel cells to economically capture $CO_2$ emissions from gas-fired power plants.

ExxonMobil lists climate change and greenhouse gas emissions as key challenges in its 10-K reporting, a comprehensive annual summary of a company's financial performance required by the US Securities and Exchange commission. At the end of 2017, ExxonMobil bowed to investor pressure to start reporting on climate risk, announcing that it would start providing shareholders with information on energy demand sensitivities, implications of two-degree Celsius scenarios, and positioning for a lower-carbon future. The first report, published in February 2018, was welcomed as a positive step forward for investor disclosure, but the company remains under pressure to increase the level of transparency it provides around these key risks to its business model.[i, ii]

By taking this three-pillar approach to investment, we believe we are able to build portfolios based on companies that are generating strong excess economic returns that are undervalued by the market, and are well placed to benefit from the Sustainability Revolution. In other words, it means we are better able to provide our clients with sustainable excess economic returns.

# Stewardship

On top of our investment analysis, we also believe strongly in the importance of active ownership because it can improve investment outcomes. In our view, companies with engaged shareholders are more likely to deliver superior, sustainable excess economic returns.

Elroy Dimson and colleagues at University of Cambridge found that successful corporate engagements are followed by positive abnormal returns and that successful engagements are more likely if the engaged firm has reputational concerns and higher capacity to implement changes.[1] Furthermore, after successful engagements, particularly on environmental and social issues, companies experience improved accounting performance, governance and increased institutional ownership.

In our experience, stewardship can provide the opportunity to strengthen our investment processes. In undertaking direct, additional dialogue with the senior management of the companies in which we invest on a broad range of issues, we can gain greater insights into the quality of company management, their attitude towards shareholders and the extent to which they are addressing risks and opportunities material to their long-term success. Furthermore, it is also an important tool for validating and enhancing our data around the sustainability of companies more broadly.

A significant element of our stewardship efforts involves engagement for information. This can enhance our understanding of a company's sustainability by, for example, identifying gaps in disclosure.

We also use this outreach process to encourage companies to improve disclosure. Where companies do so, we then bring this to the attention of our data providers and can ask them to review their database and their ratings of the company. We did this, for example, in the case of Chinese noodle-producer Tingyi, which resulted in a 15% increase in their ESG rating by Sustainalytics (see Figure 4). This process creates a positive feedback loop, enhancing the quality and robustness of our data. We also believe this interaction with our data providers, encouraging them to update and enhance their ratings in a timely fashion, is an important step in improving the quality of data and transparency across the investment industry. By sharing this information with Sustainalytics, the wider investment community is better equipped to influence companies to improve their business practices, better assess their efforts for improvement, and create better outcomes for our economy, civil society and the physical environment.

## Tingyi stewardship case study

Tingyi is a Chinese noodle company, which, in our view, benefits from strong financials and a strong business model supported by competitive advantages such as a large market share in China (above 50%) and a large distribution network.

Despite finding the company's financials and business model attractive, Tingyi's ESG rating was particularly weak. This poor rating was largely to do with lack of transparency, as only around 20% of the ESG data criteria were available. The company had not produced a proper, detailed ESG report. This is usually typical of companies that have not yet formalised their ESG policies.

The team entered into a dialogue with the company to qualify and validate the data, but also to emphasise the importance of providing transparency around the company's business practices.

Following the dialogue, Tingyi appointed PWC to do a formal report, which was released in April 2018 as part of their 2017 annual report. The level of information that came out of this process increased significantly, which we brought to the attention of our ESG data provider, Sustainalytics.

We actively requested Sustainalytics review their data and rating of Tingyi. Tingyi's rating subsequently increased by 11%, from 34.6 to 38.5, bringing it more in line with the sector average in China.

We continue to monitor and interact with this company.[i, ii]

Stewardship brings other benefits to the investment process as well, in our view. It enables us to make a positive contribution to the stability and resilience of the financial system in the context of the Sustainability Revolution because we can use our dialogue, engagement and voting activity to help companies transition in an orderly fashion. We enter into dialogue with companies, engage with them, and use our votes to influence them towards a more sustainable operating model.

[1] Active Ownership, A Review of Financial Studies, RFS), Volume 28, Issue 12, pp. 3225-3268, 2015. Fox School of Business Research Paper No. 16-009, Last revised: 19 Mar 2016, Elroy Dimson, University of Cambridge - Judge Business School; London Business School, Oğuzhan Karakaş, Cambridge Judge Business School - Department of Finance & Accounting, Xi Li, London School of Economics. Past performance is not a guarantee of future results.

# Conclusion

We believe the Sustainability Revolution will drive returns in the next three to five years and beyond. It is already causing us to rethink many of our established norms across all sectors and regions. Companies have to adapt in the face of this change. We use a three-pillar approach to identify which companies are best positioned for the transition. This includes looking at the sustainability of companies' financial models, the sustainability of their business practices and the sustainability of their business models.

In doing so, we are able to identify companies where the market is undervaluing their ability to generate sustainable excess economic returns in the future. This, we believe, enables us to capture the most attractive opportunities that will arise from the Sustainability Revolution.

[i] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

[ii] The case studies provided in this document are for illustrative purposes only and do not purport to be recommendation of an investment in, or a comprehensive statement of all of the factors or considerations which may be relevant to an investment in, the referenced securities. The case studies have been selected to illustrate the investment process undertaken by the Manager in respect of a certain type of investment, but may not be representative of the Fund's past or future portfolio of investments as a whole and it should be understood that the case studies of themselves will not be sufficient to give a clear and balanced view of the investment process undertaken by the Manager or of the composition of the investment portfolio of the Fund now or in the future.