HATCHINGS
APRIL 2022 ISSUE 3

PLATYPUS
ASSET MANAGEMENT

Measuring ESG: how a quant approach is unveiling actionable insights

Here's a surprise: the more times a board of directors meets, the more likely a company will underperform.

It's a counterintuitive finding from the quantitative team at Platypus Asset Management that seems to fly in the face of expectations that diligent, hands-on management is the key to strong share price outcomes.

But it also demonstrates the power of the close working relationship between the quantitative and fundamental research teams at Platypus, who have been collaborating to discover new insights into how environmental, social and governance factors affect share market performance.

"One of the things we do here is look for the next source of alpha," says Peter Brooke, head of quantitative investments at Platypus.

"We have been constantly analysing financial statements for multiple decades now and that's all good and interesting — but what's next? Where's the next source of information?

"Outperforming the market is hard over a long period of time."

Brooke says the close collaboration between the quantitative team and their qualitative, stock-picking colleagues saw ESG quickly emerge as a potential source of outperformance.

"We believe that ESG adds alpha — that if you take account of environmental, social and governance factors in a sensible way, it will add alpha to portfolios," says Brooke.

"But if that's true, we should be able to find something quantitatively over a long period of time."

Brooke says the teams worked together to establish a framework for putting a quantitative lens over ESG factors, trying to understand what measurable factors made sense from a fundamental ESG perspective that could be applied in a systematic way across baskets of stocks.

Quantitative analysis has shown that some basket of stocks that have similar characteristics perform in a similar manner over time — but could a corresponding conclusion be made for ESG factors?

Measuring governance accurately was a particularly tricky problem to solve.

"Governance matters," says Brooke.

"Boards have to appoint CEOs, sack CEOs. They are accountable to shareholders for the performance of the business.

"They have a huge impact on the business."

But how do you measure governance?

Brooke says the team explored a wide range of measures of board and governance effectiveness, collecting several thousand data points across thousands of companies to analyse correlations.

Some indicators looked promising but proved false flags: "Has the average age of directors increased? It looks like it has. But then so has the average age of the population. So, it's interesting, but does it give you any insight into how to build a portfolio? Does it have an impact on the way boards are running? Not really.

"There's so much noise in this data you have to be really careful about saying 'because A then B'.

"We spent a lot of time thinking about whether knowing A really does imply B or not."

It's a particular problem in ESG analysis, says Brooke, where researchers tend to develop and sell an ESG ranking that shows past outperformance, but then change the method *"so you can't invest in it, it's impossible."*

The team also analysed diversity and female representation on boards, which has increased over the years: *"It's a positive story but we've got a long way to go,"* says Brooke. Other factors included directors' backgrounds, executive pay and share ownership.

And then the team looked at board meetings.

"Intuitively this is a sweet spot. You don't want too many — that's a board becoming more executive than they should really be — and you don't want too few because that's disengaged.

"No one has zero or one board meetings a year so there's a minimum.

"But what's the right number?

"And what does it tell us about performance?"

It turns out that there is a strong correlation: the more board meetings a company has, the more likely it is to underperform.

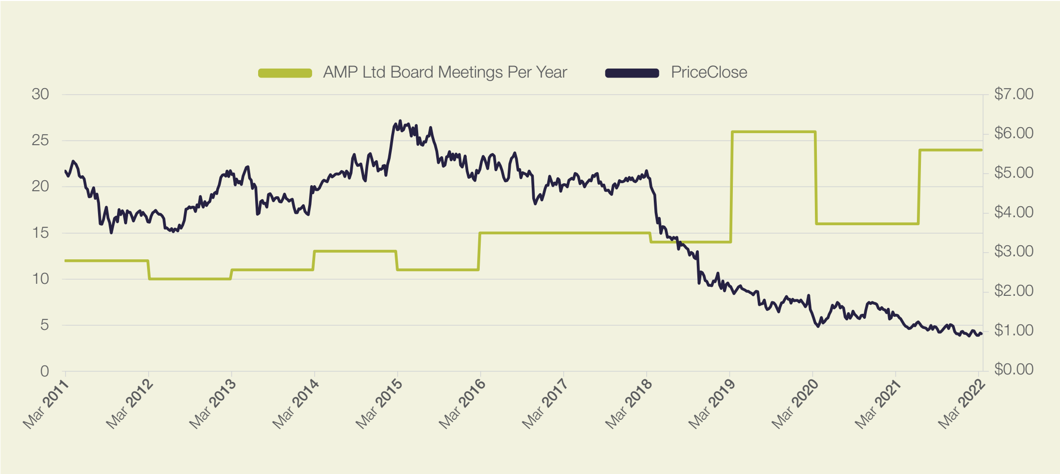
"Now remember this applies to baskets of stocks — not individual companies — but what you can say is that for a given basket of companies, the bunch that have fewer board meetings will probably outperform the group that have more," says Brooke.

"There is information in this data. This is signal that can be used to drive better portfolio returns."

So, what's driving this correlation at a fundamental level?

It turns out the seemingly counter-intuitive result is more logical than it appears.

Brooke points to real world examples of past stock price underperformance at AMP Ltd.



"When companies go through crisis, boards meet more often," he says.

"When you go through what AMP recently went through, you suddenly see board meetings increase — they have to deal with a crisis.

"But crises evolve over time, they don't suddenly appear and disappear.

"The number of board meetings is just a metric — but it does show a real link with share price performance.

"We are vigilant in counting the amount of board meetings a company has and are alert to any news of an increasing number of board meetings for the companies we invest in."