Environmental, Social and Governance (ESG) Investing

Taking account of Environmental, Social and Governance (ESG) considerations in an investment process is important. Companies that focus on the ESG aspects of running a business tend to do better than those that do not. The best companies integrate ESG into their approach to business, forming habits that become part of their respective cultures. Although portfolio managers might generally agree that ESG is important, a diversity of views sometimes even around a single stock can mean that measuring ESG is difficult. Different views can also be found from ESG data providers, who all have their own nuanced approaches that have generally been developed over a number of years.

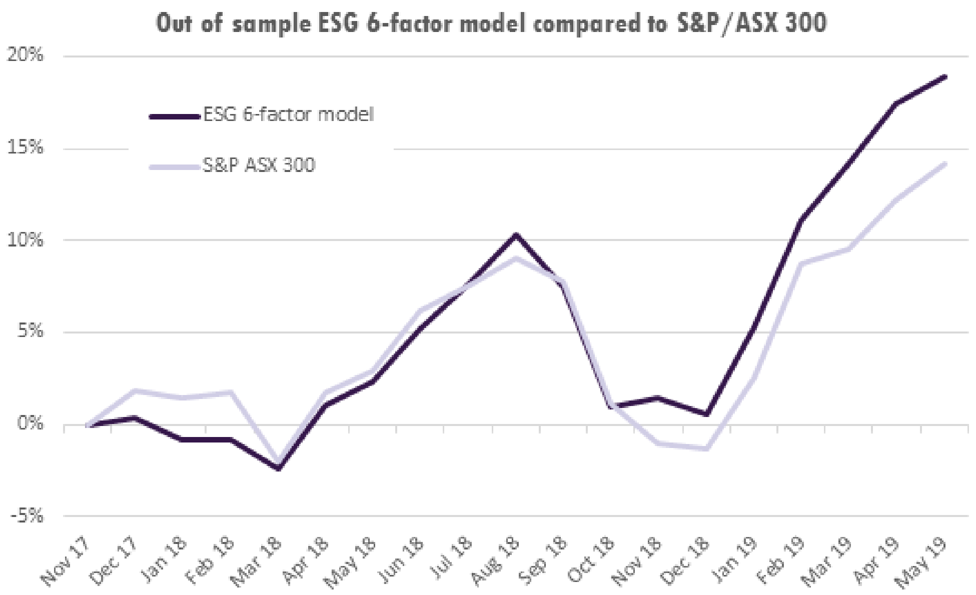
In light of this backdrop, Platypus Asset Management spent some time thinking about how to leverage the quantitative and fundamental expertise to formulate an ESG process. We have an Australian equities database that allows us to test ideas, and that has been the backbone of a factor based strategy since November 2009.As well as this, we have been investing successfully in Australian equities since 1998 using deep-dive bottom up research to select high quality companies. We approached ESG using proprietary quantitative tools to highlight risks, trends and possible returns, and then using this information to guide our fundamental research and engagement. Let's take a look at our quantitative tools.

Quantitative model

We developed the model using our statistical tools, and through a dialogue between our quantitative and fundamental teams. The model had to be succinct, sensible, and robust, using only ESG data. It also had to outperform the index. See ***https://www.platypusassetmanagement.com.au/news/esg-ranking-method*** for more details. When building a factor model, data is of fundamental importance. Unfortunately, company reported ESG data generally has a short history (not more than 10 years in the best cases) and only in recent years has the coverage increased to cover most of the index. For this reason, the dialogue between our quantitative and fundamental teams when constructing the factor model was of increased importance – the factor model had to fit with intuition. Having constructed the model as best we could, we then implemented it as part of our improvements to our ESG processes.

Ultimately, though, the only real test of a model is how it performs out of sample, and that is something that can only be achieved over time once the model is built. We have to see how the model performs using live data. The results presented previously stopped in November 2017, and produced an alpha of 4.8% per annum. The out of sample performance presented in Chart 1 matches this alpha, and what's more is higher than the tracking error over this period. This is pleasing to see as models most often do not perform as well out of sample as they do in sample.

Chart 1: Out of sample performance of ESG 6-factor model from November 2017 to the end of May 2019.



Cumulative excess return was 4.7% over this time period with a tracking error of 3.94%.

Source: Platypus Asset Management, Bloomberg.

These results give us enough confidence to continue with our ESG 6-factor model. We do not see enough evidence that makes us nervous enough to change.

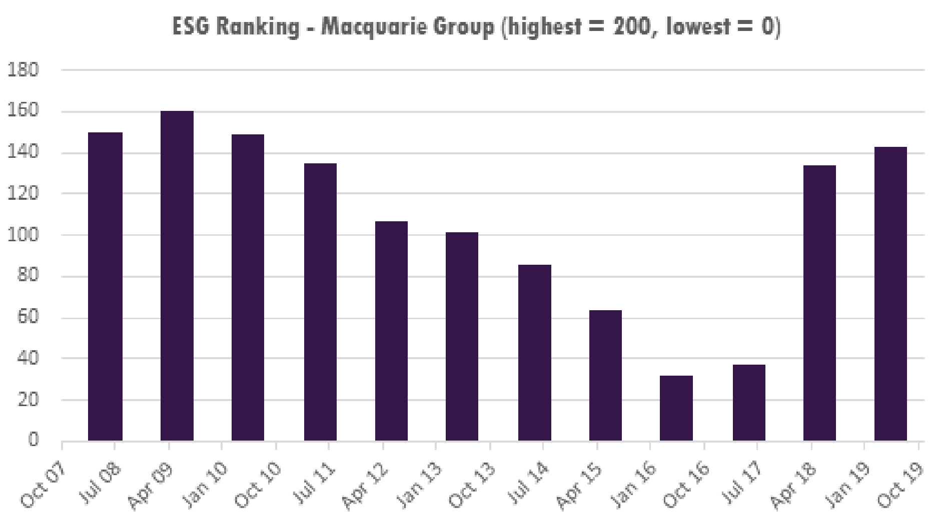
Engagement

We use our ESG model to inspire a questionnaire that we send to ASX 200 listed companies. The answers help us gauge companies' attitudes to those ESG issues that we think are most relevant to future share price performance. It is a forward-looking measure that complements the use of historical data in the ESG 6-factormodel. .

ESG example– Macquarie Group

The ESG rank for Macquarie Group has been trending lower for nearly a decade until 2016, when it then improved. This was due to improved disclosure on the part of the group. We choose to penalise non-disclosure in our model, because we think fundamentally the more disclosure the better.

Chart 2: Macquarie Group ESG rank through time. The higher the bar on the graph, the better the company ranks on our ESG 6-factor model.



Source: Platypus Asset Management, Bloomberg.

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Macquarie answered our ESG questionnaire carefully and thoughtfully. There were no issues raised that we felt needed further engagement. In the future, we are looking forward to seeing improved disclosure in the FY 2019report with respect to the recommendations of the 'Taskforce for Climate-related Financial Disclosures'. Another example of engagement with Macquarie was with respect to Delaware Investment Advisors, a funds management subsidiary of Macquarie Group. Delaware Investment Advisors was investigated by the SEC following allegation of an ex-employee that representatives of the group were aiming to defraud potential and existing clients. We engaged with senior management at Macquarie and they answered all our questions well,and took our concerns seriously.

Example – Oil Search

One part of our ESG questionnaire focuses on recycling. Oil Search operate in remote areas of Papua New Guinea (PNG), but do not recycle. We spoke to the company to discover why, and found they had considered their options around recycling, but that there are issues with recycling and other infrastructure within PNG. The overall economy has not yet developed infrastructure to support recycling, and the environmental costs of recycling offshore (in Australia or elsewhere) outweigh any environmental benefits from doing so. Oil Search continue to assess the issue.

Summary

Our ESG 6-factor model outperformed out of sample. The outperformance of our model is particularly pleasing. It supports that idea that ESG factor investing can form the basis for a factor portfolio, and can be considered as more than just a compensation for risk. We use the factor model as a basis for our ESG questionnaire, and then engage with senior management on specific issues that we deem relevant.

Where possible, we use engagement to influence and improve company behaviour across a broad range of issues. We think that a constructive dialogue between investors and companies is the most productive method to effect change.

Platypus Australian Equities Fund spotlight on ESG video

To learn more on how the Platypus Australian Equities Fund apply Environmental, Social and Governance ratings in regard to stock selection, watch our video here **(https://www.youtube.com/watch?v=WxrKbCQP7-U)**

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