ENVIRONMENTAL, SOCIAL AND GOVERNANCE

UK Smaller Companies team's investment approach to ESG matters

Investing with an embedded approach to ESG

In recent years the letters E, S and G have never been uttered more. These letters in the context of investing stand for environmental, social and governance and we welcome the fact that they are gaining so much prominence.

Given the amount of data and insight amassed on these topics alongside the proliferation of information on social media, it is no surprise that consumer preferences and government agendas have shifted dramatically towards these three words. So too has investor interest. Companies must be cognisant of the ongoing energy transition, as well as changing sentiment towards social norms, occupational behaviour and the firm's wider impact on society and the environment. We are increasingly asked if ESG factors are important to us as investors and how exactly it is that we incorporate ESG analysis into our portfolio construction.

Our approach to ESG investing

Our approach to ESG investing is (and has always been) embedded in our investment process. This is the same process that was put in place when I joined in 2002. Our "4Ms" process is used to assess companies and the industries they operate in; a valuation overlay is then applied to ascertain whether, in our opinion, we are paying the right price for that company. The "4Ms" process includes an analysis of; *model, money, management* and *momentum*.

Model

When we analyse business *models* a key part of our philosophy is focussed on their sustainability. Many factors contribute towards a company's ability to create enduring franchises. Companies that have positive impacts on the environment through efficiency gains or otherwise will often thrive as a result.

Money

ESG factors also have an impact on a company's *money* or financial position. If a company is subject to increased regulation or industry specific taxes this will impact a company's cash generating ability. Furthermore, it is rarely easy to assess the quality of a company through the use of pure financial data and industry analysis.

Management

A determination of the quality of *management* and key decision makers is one of the most important parts of company assessment. Our belief is that Management teams that have a long-term focus, a good track record of shareholder alignment and understand the sustainability or thematic dynamics at play in the industry are more likely to outperform those that do not.

Momentum

Finally, earnings *momentum* refers to the ability of a company to over-deliver against market expectations and grow earnings strongly into the future. Success here relies heavily on a sustainable strategy being put in place by a strong management team that is overseen by an experienced and independent board.

We believe ESG factors impact all parts of an investment case often implicitly, not explicitly. The effectiveness of a company's corporate governance structure and the impact a company has on the environment and society, we believe, are just as important as more traditional indicators of quality such cash flow or returns on invested capital.

A company's ESG characteristics directly impact how it is valued. All these factors influence the price multiples the market is willing to attribute to a company's earnings or the cost of capital used to discount its cash flows. Our core belief is that companies that score well on ESG and sustainability factors warrant a premium over time.

Investing for the long term

Does this mean we only invest in companies with strong green credentials or perfectly diverse boards? No, we do not. We believe how a company is valued tomorrow is in many ways more important than how a company is valued today. Which is why we do not automatically exclude companies that do not score well on ESG metrics today.

For instance, if a corporate board or management team are committed to improving governance or reducing carbon emissions, we believe there are positive returns to be generated from the increasing earnings multiples the market would be willing to attribute to these stocks in the future. Indeed, as active investors we also see it as incumbent upon us to use our shareholder influence to effect this change. We use the access we have to management to challenge their thought processes or raise awareness of issues. We would also make the point that this is a privilege not afforded to managers of passive investment products. Our proactive engagement with companies is extensive: we hold approximately 300 meetings with investee companies each year. During the year to 31 May 2023, we undertook 126 ESG interactions or engagements at which a variety of environmental, social and governance issues were discussed. During these exchanges, the Team raised environmental issues at 60 of the meetings, social issues at 48 of the meetings and governance issues at 57 of the meetings.

Ultimately, our job is to try to maximise shareholder returns and that means we need to have an investment process which accommodates, not just appends, the importance of ESG analysis and takes into account all the different factors that drive earnings and valuations 'today and tomorrow'. We believe our process does this and has been integral to the performance delivered so far. Since I joined in 2002, the Henderson Smaller Companies Investment Trust has produced a cumulative NAV total return of 1,119% versus our benchmark (the Numis Smaller Companies Index) which has returned 659%* and outperformed the benchmark in 16 out of the last 20 financial years.

Neil Hermon
Fund Manager
The Henderson Smaller Companies Investment Trust plc

Source: Janus Henderson Investors, from 1 November 2002 to 31 May 2023 on an ex par NAV total return basis.

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