Ep66: Sustainable Investing: Pro Tips from Sarah Bratton Hughes of Shroders

March 12, 2021

PATTI BRENNAN: Hi, everybody. Welcome back to "The Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

By popular demand, we have Sarah Bratton Hughes back with us. Now before we get started, I want you all to know that Sarah is the mother of a five and a half year old. Today is the early day of school. Before we started Sarah said, "You know Patti, I hope that my son stays out and doesn't interrupt us, but just so you know, in case he does, I tried to keep him out but he might interrupt us."

I will tell you all who are listening to this, I said, "Sarah, you're talking to the mother of four children. Believe me, I get it."

I can't tell you the number of times I was talking with clients, and I would literally have that panic look on my face like, "No, no, don't say anything." I would put my finger up to my mouth, "No, no, be quiet, be quiet, be quiet." The kids would tiptoe and etc. Hey, if your son needs to come in, if you want to put on your mom hat, by all means, have at it.

In the meantime, thank you so much for joining us today.

SARAH BRATTON HUGHES: Thanks, Patti. Thank you for having me.

PATTI: What's your son's name?

SARAH: AJ, Andrew James.

Patti: AJ, OK. AJ, listen up to your mom because we have America listening to her today. Be forewarned, she is the expert, and you got to listen to her also. Let's start out. Let's start, pick up where we left off in the last broadcast. It was really interesting.

We were talking a lot about policy, and how governments can influence behavior whether by imposing new laws or tax policy, etc. What would you refer to in terms of the factors? I understand this term float around ESG factors referred to as non financial factors. How do you think about those when you're selecting securities? What's the data that goes around all of that?

SARAH: Sure. The first thing I think about is that you often hear as ESG factors as being referred to as non financial factors. I actually think that's a mess. ESG factors are pre financial factors. Why do I think that? Let's just take the S&P 500. In 1975 just 13 percent of the S&P 500 was in intangibles.

If you think about intangibles as human capital, R&D, basically all those things that you can't touch, like your plants, your products.

At the time, the S&P was 13 percent of that market value was in the intangibles. Today, that number is 90 percent of the S&P is now in intangible. That's in people, that's in R&D, that's in patents. It's in all of these intangibles that are hard to put a hard market value on.

Also, what is important, and we saw this in the construct of a lot of people trying to understand how financially material sustainability or ESG factors were. If you look at your same S&P 500, and you look at the 10 K, so these are the official filings that companies placed with the SEC that talk about the risks to their business model, the top 100 companies...

We looked at the top 100 companies within the S&P 500 of them, all of them have at least one ESG risk in their 10 K. Most of them have multiple. What's that saying to me is that if these factors are important enough for companies to file as risks with their regulators, they're important enough for us as investors to be taking into an account when we're making investment decisions.

We look at a number of factors, and we actually focus on the stakeholder model. Rather than breaking it down simply into E, S, or G, we're focused on how a company is managing all of its stakeholders, all of its material stakeholders, because to us that's key to how not only will they survive in the future, but how they'll thrive in the future.

We're looking at it holistically from a stakeholder perspective how a company is treating its customers, its employees, the environment, regulators, communities and also just as important shareholders. Us, as shareholders, we're a stakeholder as well. We focus on it much more from a materiality perspective. I'll use Schroders for an example.

Schroders, we're an asset management firm. First and foremost, we have to be the leader at maximizing risk adjusted returns for our clients. Our customers are a very large stakeholder. We're a service industry. Our employees, there's a lot of human capital that goes into our roles here. They're a very important stakeholder.

The third very important stakeholder is we operate in 32 companies around the world. The global regulators are definitely important stakeholders to us. Very different if you're looking at somebody like an airline, who'll be focused on customers, regulators, but the environment, a large stakeholder with there.

We're focused on understanding the material stakeholders per industry, per jurisdiction that a company is operating. Then we're using both traditional data but non traditional data to help us assess how companies are managing those stakeholders over time.

One of my favorite stories about what we do in terms of using non traditional data is we'll often look at companies' Glassdoor or their local equivalent scores. Before everybody rolls their eyes at me, we will never trade off the Glassdoor score.

We know that most people that go to Glassdoor to write reviews are employees that perhaps aren't the happiest, but that's, as investors, what we want to understand and what we want to find out.

Most managements that come in and speak to us are only telling us about 30 percent about what's happening in their company. Very rarely do we have a management team come in and say that they have a poor corporate culture or their employees are unhappy working there.

For us, we had an Indian bank in one of our portfolios. We found that their Glassdoor equivalent two branches were flying to us for having aggressive sales tactics, a high pressure environment, and a poor work life balance.

Many of you on this podcast will automatically start thinking of a big US similar bank that had a similar problem. It resulted in fake accounts and significant reputational as well as litigation costs for that company. That was the first thing that went off in our head.

We decided to engage with the management team on that holding and what we were focused on was understanding what policies and procedures they had in place and what they were doing to ensure that they wouldn't have a similar type of scandal.

This particular Indian bank on a Friday night in India got on their CFO, the CEO, their head of HR, as well as the two branch managers within the two branches that were having the largest problem.

We were satisfied, from an investment perspective, that there wasn't that risk there in terms of the scandal, so we continued to hold the position and monitor. That's just an example of how we're using both traditional and untraditional data to help us look at some of these factors that wouldn't traditionally show up on a balance sheet or an income statement.

PATTI: That's so interesting, Sarah, because you and I both know the name of that bank here in the United States. It's very interesting. I got to tell you, I'm very impressed because if you were with a different firm, a different firm might just say, "We're going to sell this. We don't want this. We don't want to own a bank where this could happen all over again."

Instead, what I'm hearing is that you chose to engage with senior management and help them to begin to change that culture and make sure that they address that issue so that they could continue to grow and take care of their employees, and reduce that high stress culture and the domino effect that often occurs in terms of their business practices.

I'm just impressed. I wouldn't have thought, but perhaps I should've known better because I know Schroders. You guys operate at a whole different level in terms of…Not so much activism. Again, what I'm hearing is that you just wanted to understand, give them the feedback that you had learned, and get a sense of how they might respond.

Awareness is the first step in any problem and pointing it out. Clearly, senior management was receptive to that feedback. They may not have appreciated it. They may have been maybe a little surprised. Calling them out on it, kudos to them because they did something about it too.

SARAH: Yes, definitely. I would say we're active owners who are not activists, particularly in the traditional sense of the word. It's about engaging and really unlocking that long term value for our clients.

PATTI: Let's do a pivot here. I'm really curious of what you think about some of the more important policies that were just enacted by President Biden. There are a lot of stuff that happened very quickly once he got into office. What are your thoughts about all of that?

SARAH: I think particularly regarding the flurry of executive orders we saw on day one, there was a lot packed in there, and there was a lot packed in there from a sustainability perspective. A lot of it, not as surprising, at least, from my seat.

There's two reasons for that. One, that the Biden Harris campaign did have a campaign that was much more focused around equality, whether that's an environmental, justice, or individual equality. You had that focus within their campaign. Then, what his actions before he took office, really proved that it was not just rhetoric.

You saw him named John Kerry as climate czar to the National Security Council. The first time you've ever had anybody on climate, focused on that. You saw Gina McCarthy heading the EPA, a fellow graduate of Fontbonne Academy out of Milton in Mass, so Go

Ducks. I would like to highlight that.

You saw Brian Deese, who was the former head of sustainable investing at BlackRock. He's part of his National Economic Council. I always say actions speak louder than words, and his actions were actually speaking just as loud, if not louder, than some of his campaign promises.

PATTI: If I may, let me talk about the elephant in the room because I think that a lot of people were surprised on him closing down the Keystone Pipeline. It was cold turkey. Did that surprise you?

I don't know, maybe he did campaign on that. I don't recall, but I think the fact that that happened so quickly after him getting into office surprised some people. Then what's the message that he is sending with that action?

SARAH: I think with that action combined with his other executive orders, he is sending a message that he wants the US to be a leader on climate action. I don't think I was surprised about the Keystone Pipeline because of the amount of climate that they had focused on, or climate promises that Biden had made throughout his campaign.

Harris actually didn't make a lot of headlines, but four days before she was announced as the VP nominee in the summer, she had co sponsored a bill with a OC really focused on climate change, and both climate as well as economic justice.

What I would say, and we had touched on this a little bit in our last podcast, on the White House site, you can go in and read about each one of these executive orders.

For those in the US, I think a lot of concern about is, "OK, you're shutting down our pipelines, but what about a lot of big emitters that are not here? There's a lot of other countries in the world who are larger emitters, aren't doing anything about it. They're going to have the economic advantage because their costs are going to be lower."

What I think should give comfort to those who are very concerned, not only about what's happening in terms of emission within our own borders, but also outside of our borders and particularly around the argument that if we go all in on green, there are other nations in the world that would continue to use fossil fuels, and it will be more economically favorable for them.

What is important to understand within the revoking of the permit for the Keystone Pipeline is that there was clear acknowledgment that most greenhouse gas emissions originate beyond our borders. That the US is prepared to utilize vigorous climate leadership in order to have a significant increase in that global climate action.

You now have the US alongside the EU, particularly putting their flags in the ground on being climate leaders.

PATTI: That's really interesting, and that was their way of sending that message. When they do that, they are acknowledging that maybe temporarily, it's going to be painful. I thought the point that you brought up in the last podcast was – for me, it was a real epiphany – that actually some of the green technology is more economic than fossil fuels. That to me was incredibly helpful.

Sometimes you do have to take away the candy jar and make it cold turkey which is what that felt like. You shut down the Keystone Pipeline. All of those jobs are lost. Again, I'm playing the other side of it, couldn't we wean down off of that?

I think it's important for listeners to understand that the pipeline was being built. Why build something that you don't want to encourage Americans to be using, the fuels that are going to be flowing through those pipelines?

Let's stop that. Let's stop investing in that. Put that money towards other things that, frankly, short term pain, but long term gain, are actually more economical than using fossil fuels. Do I have that right?

SARAH: Yes. I'm going to say something that is pretty controversial amongst my peers in the sustainable investing universe is that, and I've said it before…

PATTI: Go for it. Go for it, Sarah. I'll…

SARAH: I hate the term ESG investing. Many people say, "Why do you hate that term?" It's because it elicits an emotional reaction from people.

Half the people in the room are super excited and want to hear what I say. Half the people are in the room rolling their eyes and thinking that I'm out hugging trees and saving the world.

When you take it out of that ESG investing, and you talk about it in terms of the long term sustainability of a company's business model, the durability of cash flows, and returns over time, then you're speaking everybody's language. That's really what sustainable investing is. Yes, it's a different way of hitting the home the same point that you had just said, Patti.

PATTI: Sarah, just for our listeners, can you define what E stands for, what S stands for, and what G stands for?

SARAH: Sure. E stands for environmental and probably the most controversial from a US construct, the least controversial from a European's construct, [laughs] is on environmental and how you're taking accounts, the externalities that you create on the environment within your investment process.

S stands for social. You'll be looking across…And social is a very broad bucket. It can withstand everything from cybersecurity to diversity, to human capital management labor. What labor is used throughout your supply chain. Very broad bucket on social.

G. Somebody else referred to this, but I love this phrase is, "G is governance." That's the mother of E&S. That's having the strong governance in place that's going to result in more positive environmental or social policies.

I always say I don't love the term ESG investing enough for that ET, because many people think it's sacrificing return at all costs to have a greener environment.

Sustainable investing is quite the opposite. It is understanding and analyzing the externalities that your investments create and understanding how they could impact their value over time. I'm looking to maximize long term return.

PATTI: It's interesting because your visceral reaction to ESG is like my visceral reaction to the word budget.

People just don't like the word budget. It's got a negative connotation and it makes people feel like they are giving something up, that there's sacrifice.

We call it defining what your cash flow needs are. It's not a budget. You're not giving anything up. You're defining what you would like to have coming in on a monthly basis and how that is going to be used. That is so interesting how it also relates to ESG.

I see that also. You do get the rolling of the eyes and tree hugging kind of response, and then you've got people who are passionate about it. The sustainability argument or the focus on sustainability, that is what it truly is all about.

Here's a question. We've seen sustainability, ESG, whatever you want to call it. That has become a greater focus in markets. Frankly, a lot of those companies and markets have already risen sharply. Do you think that it's too late to invest in those industries that are focused on ESG and sustainability, or do you think that there's some runway left?

SARAH: I think there's a massive amount of runway left for more than a few different reasons. I would say maybe at the tails, you have some industries that have been priced to perfection. You've had some industries where a baby has been thrown out with the bathwater. Actually, where you have the ability to make a lot of money is on this 90 percent in the middle.

From a policy perspective, there's a lot coming down the pipeline very quick and furiously that are going to or has the ability to shift valuations within your portfolio very quickly. We are seeing increasing calls for costs of carbon globally. 25 percent of the world's carbon is now being priced.

Even China is going to begin pricing carbon – albeit not what we think it should be even be close to – but they're going to be putting a price on carbon.

What we've seen in the executive orders that was actually buried in one executive order – I pulled it out as its own for our investors here at Schroders– is the Biden administration has started a committee to look at the social cost of carbon, the social cost of nitrous oxide, and the social cost of methane to estimate and monetize the damages associated with the incremental increases of greenhouse gas emissions.

They're asking for interim recommendations very shortly, early in the summer, and then final recommendations by January, 2020. It's not just here or what we've seen happen north of the border, north of us. Canada has actually come out and put a price of carbon to reach to $170 a ton by 2030, one of the most significant prices out there on the market.

What we're seeing is pockets of this carbon pricing coming up. If that happens, we're in for a hockey stick type transition across a number of industries, my own industry, the asset management industry, is not avoided at that. If you look at Scope 1 and 2 emission, so those are direct emissions. You'll see that asset management is nowhere on the chart at all.

We work in offices, the most emissions that we have from a direct perspective is flying around on airplanes to visit our clients. However, if you look at downstream Scope 3, so that's the emissions within our supply chain. That's the emissions in our investments, that's where 97 percent of emissions live from an asset management perspective.

The industry itself actually moves up to third, right behind our oil and gas industry. You're going to see industries that you would probably not associate as high carbon intensive industries. They're going to be exponentially impacted. I also think from a theme perspective, it's constantly ever evolving and ever changing.

That's what's interesting about sustainable investing. One of my favorite themes that I'm doing a lot of work on right now has nothing to do with the environment, it has to do with this concept of quality jobs.

What the concept of quality jobs is how you deliver a double bottom line return, how do you invest in your employees, and treat them as assets, instead of treating them like a liability line that has historically happened here in the US, as investors have looked at companies how to minimize costs, all too often it happens at the employee line?

Well, you can only cut costs on your employees so long before it comes back to you in terms of turnover, in terms of poor service, in terms of disengaged employees, costing you market share and market value over time. Concepts like these that are maybe not their traditional sustainability concepts that people think about everybody flocks to the environment and climate.

You're going to see other concepts coming out that there's going to be significant tailwinds from the somatic perspective on how you invest in them. There's also significant value to be unlocked as well when you're really challenging some of these traditional norms.

PATTI: That is so interesting. I love that theme, quality jobs. When you elevate an employee, when you elevate another human being, it's got a multiplier effect that I don't know that many companies take the time to measure that. From my perspective, it's powerful, absolutely powerful.

Sarah, I can't thank you enough for joining us today. This was fascinating. I can't thank AJ enough for listening to his mom and letting her bring all of her brilliance out to us and all of our listeners. Thank you both for joining us today. It was fascinating. This is the beginning of hearing from you and Schroders on this topic. When I think about sustainability, I think of Schroders, so I'm so grateful. I can't thank you enough.

I'm grateful to Schroders for taking us up on the invitation to join us today. Thank you, Sarah.

SARAH: Great, thank you so much. Thank you for having me.

PATTI: Thanks to all of you for joining us again. It's been wonderful to invite you into our office in this manner through the podcasts. Thank you so much for your feedback. If you ever have any questions either based on this topic or any topic, please feel free to go to our website at keyfinancialinc.com. Until next time, I'm Patti Brennan. Thanks so much for joining us today.