# Global Stewardship – monthly bulletin

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The following is an example of a recent piece by the newest member of the Global Stewardship team, investment analyst Abhishek Parajuli. Abhi joined Baillie Gifford in 2019 and has previously worked in our Emerging Markets department. In his note, Abhi argues that investors should think about which companies they can help do better, rather than just buying into those with the highest ESG scores. This philosophy fits well with the Global Stewardship approach to engagement, where we accept that no company is perfect and seek to be pragmatic and constructive long-term shareholders.

## Growth ESG: investing in companies that need to catch up

Doing what's 'right' often involves rejecting what's 'easy' and putting in extra work to get better results. It applies to many walks of life, from personal health to politics. It also holds true for ESG investing where environmental, social and governance considerations are used to pick stocks. Yet businesses are often scored on ESG by what amounts to a box-ticking exercise rather than a more thorough endeavour.

There is typically a fixation on trying to predict which ESG-related flaws from their past might return, with the guiding question being: 'What could go wrong?'

There follows a rush to crown winners who have done the most to address ESG issues. But this takes no account of potential or opportunity – the factors that growth investors are steered by to find the market leaders of tomorrow. So, what would Growth ESG investing look like?

Instead of piling into firms that already tick all the right boxes, it would focus on laggards in need of improvement but capable of making the change. Fund managers would now have the much harder task of differentiating the stubbornly bad from the potentially good. And this would require bottom-up analysis to find hints of future change rather than taking the easy route of relying on dredged-up summary statistics of historical data.

## ESG improvers

Adopting this mindset has clear benefits. Firstly, it's good for returns. Much of the $300bn that has flowed into ESG-focused funds since 2015 has chased the same 'best-behaving' companies. That makes for a crowded space with inflated valuations. The real opportunity lies in finding companies that can grow their ESG profiles.

ESG improvers beat ESG leaders by one percentage point on an annualised basis, according to a 2015 study by the financial data provider MSCI, as well as outpacing its World Index by two percentage points. Subsequent studies by Alliance Bernstein and Rockefeller Capital Management reinforce the idea that focusing on ESG improvers can really pay off.

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Growth ESG is also good for society. Celebrating ESG leaders is less useful than nudging along firms just starting out on their journeys. As investors we have the power to shape outcomes, instead of just tracking them. This change in mindset is particularly important in emerging markets, where there are more laggards than in developed regions. The existing model shuns companies in these territories, even though they need the most capital.

Images we've seen of broken healthcare systems during the Covid-19 pandemic should remind us how far capital can go in such countries, and how wrong it would be to pull out simply because we cannot tick a box. With Growth ESG, the glass is suddenly half-full and money flows both to where it can have the most effect and where returns on capital can be higher.

Changing our mindset from the old ESG of crowning champions to the Growth ESG of picking and prodding improvers, unlocks tremendous social and financial value. But it is only half the battle.

The metrics used for ESG investing are also broken – especially when it comes to the 'S' in the acronym. There is no obvious measurement for 'social', so analysts use proxies instead such as fair pay, human capital management and data security. But this misses the point. What really matters is whether companies leave societies better off.

## Engaged investors

If you define the metrics narrowly, they become easy to game. Imagine a clothing manufacturer with factories in Bangladesh where workers' rights are a challenge. To 'improve' its ESG score, the firm shifts fabrication to a highly automated plant in Mexico. The risks from labour issues dwindle, so its ESG score goes up. How does this help children who are subsequently pulled out of school in Dhaka and Chittagong because their mothers' factories have been shut?

The right thing to do would have been to engage with the company to improve standards within a Bangladeshi context. That is Actual Growth ESG. Both the mindset and metrics of ESG investing need to change if it is to generate sustainable returns and be a force for good.

By this point, just about every company knows how to talk the ESG talk. So, it takes fundamental research to sift progress from platitudes. Our investment teams are used to judging the sincerity of commitments about investing for growth, so we might have an edge here.

And we must debate carefully what the words behind the letters really mean. Otherwise, there is a danger that the industry will coalesce around what is easy to achieve, instead of what is the more demanding – but correct – course.

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