In focus

Seeing ESG through a US Lens

March 2022

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Marina Severinovsky
Head of Sustainability, North America

Schroders is committed to sustainability because we believe that integrating ESG (Environmental, Social, Governance) factors can lead to improved outcomes for all stakeholders. First and foremost, it could be used to mitigate investment risks. The strength and speed of the global shift towards sustainability creates significant risk for the companies that get left behind. As a result, rigorously assessing ESG-related characteristics is crucial to effectively managing portfolio risk. Second, ESG could create investment opportunities. We believe that a combination of identifying opportunities for growth, and active engagement with companies, can help enhance long-term returns. Finally, we do believe that the impact of their investments is something that clients increasingly care about. In the modern, interconnected world, we are all ever more aware of the impact that our behavior, from our purchasing decisions to our investments, can have on society and the environment. Therefore, it is crucial that investments are aligned with the sustainability objectives of clients.

All of this is as true in the US as anywhere else that Schroders operates. Yet there is a general perception that the US has lagged when it comes to ESG or sustainable investing.

This has been true from the perspective of regulation, with the Securities and Exchange Commission and Department of Labor potentially set to play some catch-up this year. The US, unlike other regions, does not yet have a stewardship code that addresses ESG in any systematic way, disclosure requirements are a work in progress, and fund standards or taxonomies have not yet been established.

There are also, admittedly, some elements of ESG that are more controversial and divisive in the US than elsewhere. We have already seen rules proposed (though not yet adopted) by various states (e.g., Louisiana, Missouri and Texas) to prevent a company from doing business with any entity that "discriminates" against or boycotts firearm manufacturers/distributors or energy companies, and we know of other states with meaningful reliance on fossil fuels that could enact similar restrictions. Notably, the state of Maine has gone the other way and passed a law that requires the Maine Public Employee Retirement System to divest from fossil fuels.

So, the US is indeed different; however, we think that US investors are no less interested in sustainability than others globally, they simply need to see how ESG aligns to their own values. And asset managers must communicate with US investors on their terms, finding areas of commonality. We cannot just take an approach followed in the UK or Europe and impose it onto the US market. Instead, we have to meet the US clients where they are and show that sustainability is certainly a broad enough discipline to address their interests as well. In short, we need to consider ESG considerations through a US lens, whether that is in our thought leadership, thematic research, company engagement or product development.

Our own sort of climate

What are the top ESG issues in Europe? To say that climate in number 1 and number 2 is not much of an exaggeration. European governments, regulators and investors have placed a strong focus on decarbonization. And the US, a vast land rich in natural capital resources and biodiversity, encompassing within it many different terrains and ecosystems, has good reasons to care about climate too. The elevated physical risks of climate change, such as wildfires, hurricanes, extreme heat, and flooding have increasingly affected many Americans. The preservation and conservation of our nation's abundant natural resources is a core part of the American psyche, associated with great historical figures like Theodore Roosevelt and manifest in the expansive network of our national parks. US investors, no less than those around the world, want to preserve this natural heritage for their children and grandchildren, and US companies, alongside global peers, have accelerated their net zero and other voluntary climate pledge commitments. After many years of feet dragging, governments, corporates and investors globally are becoming more aligned on cutting carbon emissions and limiting temperature increases.

However, we must also be conscious that change does not happen in a vacuum. Many regions of the US are reliant on natural resource extraction and production, and many sectors of the US economy are driven by fossil fuels. A transition takes time to effect, and we must support the companies, people and communities who are required to adapt.

Transition financing, which offers capital to high-emitting companies or industries, in order to support their shift towards a climate-neutral or climate-positive future, is needed. Rather than excluding such industries or issuers, Schroders is committed to active ownership with companies as they navigate this path. Moreover, we believe regulation in the US, at some difference to the approach in Europe, will focus on best-in-class instead of exclusions, and allow for transition financing to encourage engagement with problematic industries or issuers and avoid surrendering influence via divestment.

As we think about how to assess transitioning companies, who can be thought of as "evolvers," Schroders can access our proprietary framework* around Avoided Emissions, designed to measure the potential decarbonization contributions of companies that are seeking to adjust their businesses and developing products and services that can drive significant reductions in economy-wide emissions in the future. In this way, even companies that currently have higher carbon intensity could become "enablers" of climate positive change over time.

In addition to companies, we must also support workers and communities. In the US, the concept of a "just transition" is especially relevant, given how climate change mitigation and decarbonization efforts affect people in various US regions and industries, and the desire on the part of most Americans that these folks not be left behind. Thus, a just transition in our view means combining climate action with fair socio-economic distribution and giving impacted communities a voice. This includes engaging with workers, unions, and communities that will be affected, providing them with a plan for income support during the transition and proper training or retraining of employees to ensure they can transition to valued work in the future.

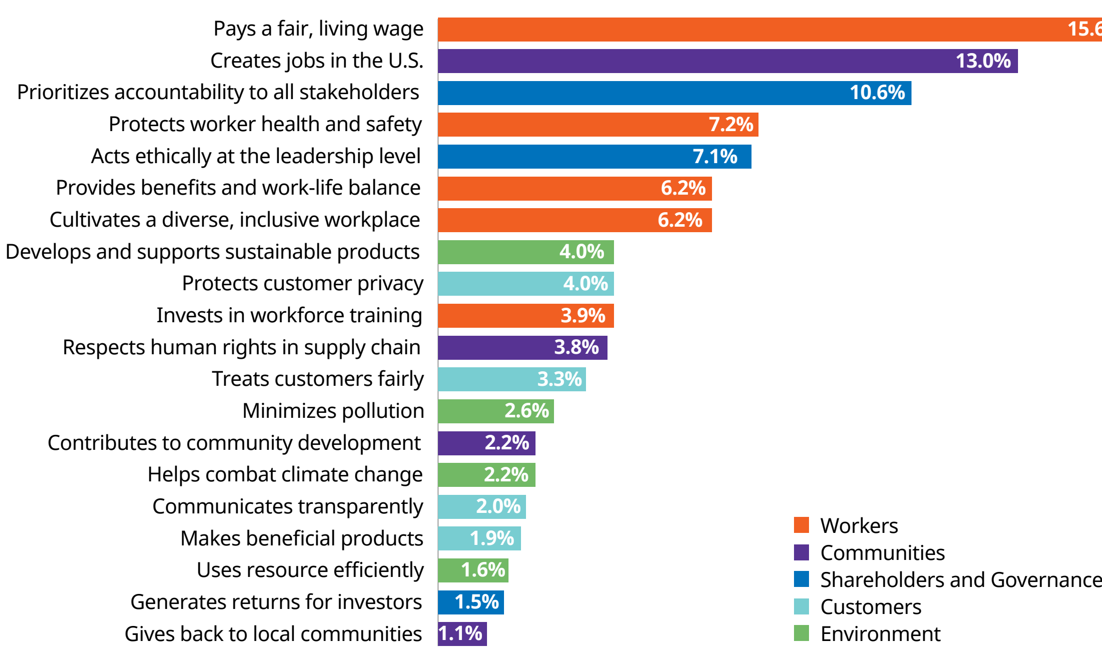
ESG begins with E, but it does not end with it

While climate is certainly a critical issue, from both a risk and opportunity standpoint, we observe that among US investors, there is much more of a balance towards social considerations as well.

In the context of the Covid pandemic especially, in the absence of the social safety net that exists in other parts of the world, and in the fraught political climate of recent years, US investors (like all Americans) keenly feel the issues around financial inequalities, social and racial disparities, and the challenges faced by workers. Issues like economic inclusion (education and training, quality work, living wages, gender equality, workforce diversity), sustainable infrastructure, and good health and well-being (access to healthcare) are meaningful to a majority of US investors, according to recent research from JUST Capital. It is important that these US investors understand that their priorities also fall squarely within the realm of sustainability.

In terms of our own priorities at Schroders, social issues are very much a focus of our thematic research and our engagement efforts. We offer insights to investors on topics around human rights and human capital management. In fact, under the tagline "People Drive Returns," we are currently building a new research framework and testing a variety of human capital metrics to help contextualize the human leverage on capital employed, uncover the human drivers of firm-level productivity and shed light on the possible human impact on the persistence of returns through the cycle. In addition, our firm-wide roadmap for active ownership in the coming years identifies the six key priority areas/themes on which we will focus our efforts, and three of the six are social themes (Outlook 2022: Active ownership / Six key themes for active ownership in 2022 - TalkingPoint - Schroders – Climate, Biodiversity and natural resources, **Human capital management, Diversity and inclusion, Human rights**, Governance).

Figure 1: What are Americans' top priorities for companies today?

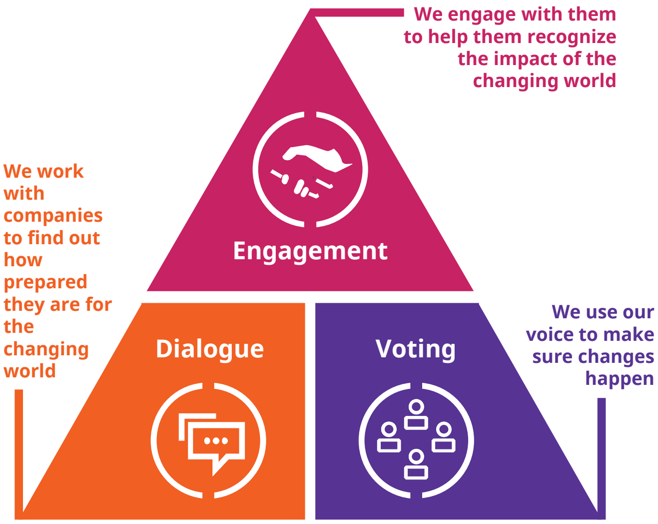


Source: 2022 JUST Capital Foundation. *Schroders proprietary tools and models are designed to enhance the research and evaluation process but do not guarantee favorable results or any intended outcomes.

Figure 2: Active ownership and key thematic priorities

Active ownership

Enhancing our analysis
Influencing company behavior



Source: Schroders.

Six key thematic priorities

Climate
- GHG Emissions
- Decarbonization
- Net Zero
- Physical Risks
- Renewable

Biodiversity and Natural Resource Constraints
- Biodiversity
- Deforestation
- Pollution and Chemicals
- Waste and Circular Economy
- Water Stress
- Responsible Sourcing
- Plastic pollution

Human Capital Management
- Health and Safety
- Wellbeing
- Compensation & Benefits
- Employee Engagement
- Freedom of Association
- Culture

Inclusion and Diversity
- Board Diversity
- Workforce Diversity & Inclusion
- Impact of Products Services on Diverse Communities
- Gender & Ethnic Pay Gap

Human Rights
- Child Labor
- Ethical Supply Chain
- Indigenous Rights
- Basic Access to Products and Services
- Modern Slavery

Governance and Oversight
- Shareholders Rights
- Executive Compensation
- Board Composition
- Governance interlinks with E+S issues

Focus on the upside

Even if there is less agreement in principle among Americans regarding certain ESG related issues, especially around climate, this need not prevent pragmatic discussion about why ESG integration matters in portfolios, purely from a better long term risk and return standpoint, as well as from the standpoint of the impact those investments have. The reality is that conversations do not always need to be about the sacrifices made in trying to reduce emissions in a portfolio. The other side of that same conversation can be about the opportunity to make lucrative investments in new technologies and solutions that can mitigate and even reverse environmental damage.

Also from a purely pragmatic perspective, we believe that we have a responsibility to try to protect our clients' capital from the risks that climate change poses. Given government and corporate decarbonization pledges, regulation, and public awareness of the issue, we expect that huge quantities of capital will be withdrawn from sectors that emit carbon and reinvested in those that aid transition. We therefore look for value in the potential opportunities created.

As investors, we believe the way we direct capital not only shapes the financial returns but also the type of impact we have on the world. The relationship between these two outcomes has rapidly evolved as we see a fundamental shift in how companies are viewed and valued. Understanding the impact that they have on society and the planet could be crucial in determining their true costs and ultimately their impact-adjusted profits. Sustainable investing has become a cornerstone of building robust portfolios that may deliver long term returns, serving the interests of both investors and society.

In the context of this, we believe that it is important to engage US investors in the sustainable investing conversation in a way that will resonate with them. Across geographies, the political spectrum, and generational cohorts, the asset management industry can seek to meet American investors on their own terms, in relation to their objectives and priorities. From a risk mitigation standpoint and from the perspective of capturing better long term returns, we believe US investors no less than those in other regions can benefit from having ESG considerations integrated into their investments.

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