Morgan Stanley

INVESTMENT MANAGEMENT

Q&A with William Lock

Seeking Sustainability

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William Lock, Head of Morgan Stanley's flagship International Equity, Global Franchise/Brands and Global Quality Strategies, discusses sustainability and his investment team's approach to, and integration of, ESG considerations.

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What is your team's approach to ESG?

WILLIAM LOCK (WL): We're all about finding and investing in companies with good prospects for sustainable or improving returns on their capital over the long term. ESG considerations form an important part of this because any material weakness in the Environmental, Social or Governance areas potentially threatens this sustainability.

Why are you doing this now?

WL: Actually, we've been focusing on the sustainability of returns for over two decades. What we've been doing more recently is enhancing and further formalizing our process. Essentially, what we do now is simply an amplification of what we've always been doing.

How do ESG factors influence security analysis and portfolio decision-making?

WL: For us, understanding how ESG factors may impact long-term sustainable returns has to be rooted in company-specific analysis. This is integrated into our fundamental, bottom-up investment process, company by company. We're conscious that companies within industries may have different "starting points" in terms of addressing their specific material ESG challenges and opportunities, but where we have identified ESG factors as material we look for evidence of incremental improvement.

"We believe good governance is the cornerstone of sustainable returns—without this, all else fails."

Why do you place Governance at the center of ESG? You call it the "cornerstone".

WL: Governance is a significant factor determining a company's bottom line and its long-term viability. A central task for management—who after all are the governors of a company's capital—is to allocate this capital appropriately to generate the best return they can for their shareholders. A corporate culture that doesn't support the effective allocation of this capital for the long term may lack the required focus to appropriately manage their material social and environmental factors.

Management teams investing capital at low returns—either through high priced acquisitions or expanding into lower return businesses—can undermine the overall quality of their business, which can then impair the ability of the company to compound its free cash flows over time. Simply put, we aim to avoid companies whose management teams allow low returns to persist long term, or who sacrifice the long-term health of a business by prioritizing short-term returns.

What signals do you look for to check for good governance?

WL: Understanding how management is incentivized is one area. It helps us assess management's motives because incentives can drive their behavior and influence how they run the company and its capital. Where we dislike an incentive scheme—which is quite often—we will engage with a company to try to change its scheme to emphasize long-term sustainable returns. If we continue to see poor incentives with no appetite for reform, then we will vote against them.

Can you give an example?

WL: With a UK-based company we currently hold, we met with the Chairman to discuss the incentive plan and our long-standing proposal for ROI-based incentives. We also wanted to ensure senior executives held substantial stock in the company for at least 2-3 years after retirement, helping ensure that in advance of their retirement no executive adopts short-term behavior to the detriment of the business. We think this has good follow-on governance benefits since management should ensure its successors are long-term thinkers. The company adopted the proposal.

How do you consider social factors?

WL: Companies that emphasize and practice social responsibility have an opportunity, in our view, to build or improve their reputation with customers, employees, regulators and other stakeholders, particularly given the importance of social media and rapid global communication. This can help underpin the sustainability of returns we're looking for.

After all, customers tend to stick with businesses they trust, which helps keep a business profitable over the long term. This is particularly important for companies that can introduce products bringing health benefits, like helping address issues including obesity and malnutrition, or companies that create innovative products to help reduce harm to consumers, such as Heat Not Burn cigarettes or e-vapor products. We believe companies that can do this are more likely to benefit over time and sustain their returns.

Do you actively exclude specific companies on ESG grounds?

WL: We don't exclude companies or industries solely for ESG reasons, unless we anticipate the risk of a material impact to long-term returns. Our Global Quality ex-Tobacco strategy is the only one we have that has a negative screen for the tobacco industry, which is a requirement for some clients.

What about the opposite—including companies because of their ESG profile?

WL: We include companies on the basis of their ability to sustain or improve their returns, rather than on the basis of rating their environmental or social credentials. However, several of our top holdings lead their industries driving improvement in environmental impact. One of our stocks, based in the Netherlands, is looking to eliminate deforestation from its supply chain by 2020, and make sustainable agriculture the mainstream. They have topped the GlobeScan Sustainability Leaders survey for seven years running.

The Software and IT Services sector, a significant weight in our quality portfolios, has a relatively limited environmental impact, but this doesn't stop them striving for improvement. One, amongst the largest companies in the world, has been carbon neutral since 2011 and 100% powered by renewable energy since 2014.

How do you consider disruption risk through the lens of ESG?

WL: We think recognizing disruption risk is an important identifier of future sustainability. For example, in Energy, we believe investors need to tread ever more carefully. Companies who traditionally deployed capital on a 20-30 year timeframe now face pressure on two fronts. First, there is greater oil supply caused by technological progress extracting hard-to-access oil, including shale. Second, there is the looming reality of peak demand for fossil fuels given the gaining traction of renewables and the trinity of electric vehicles, autonomous driving and the shared economy. This raises concerns for us that energy executives could be deploying capital in a value destructive way, increasing the risk of stranded assets, write-downs and the long-term sustainability of their free cash flows.

Even in "old economies" we see the impact of innovation. Responding to consumer risk in tobacco, innovation is creating an investment landscape of the "haves" and the "have nots". Two companies in this highly concentrated industry are leading the innovation and distribution of next generation, reduced harm products, leaving others trailing in their wake and facing significant expense in order to catch up, or to even sustain what they have.

Consumer demand for better health and wellness is also a force for change. Sugar reduction is a case in point. Traditional carbonated soft-drink suppliers are working hard to change sugar-based formulations and modify their product offerings to keep ahead of what might be regulatory or tax risk, or both. The investment opportunity lies in seeking companies that acknowledge change is coming, combined with the wherewithal to do something about it.

Information is a central output of the digital era. How do you consider this in a social context?

WL: The digital landscape is rapidly advancing, especially with the advent of the cloud. Consumer data is key, bringing both opportunities and risks. In insurance, for example, data is central to the industry as a basis to differentiate risks, which is the foundation of underwriting. Any breaches in data security could be very costly. Likewise, the abuse of data usage could be too; social media profiles and genetic markers are both controversial. Customer relations is likely the dominant risk in insurance, based around the need to treat customers fairly. Failing to do so can result in heavy penalties from the regulator, or attract class-action lawsuits. Regulators can tighten rules or apply hindsight in an expensive way. Underwriting in non-life can be discriminatory in effect, if not intent—by gender, race, or income level—and pricing structures can disadvantage those who don't shop around.

What about the software industry?

WL: Data breaches, the risk of being hacked, government access to, and the monetization of consumer data all present social risks. For very large software companies, being such global and arguably borderless enterprises, they face political risks as well. The industry has a reputation for creative tax strategies, leading to low tax rates with help from the likes of Ireland and Luxembourg, which could attract further scrutiny. So too could the success and size of some of the largest companies in the world. In just 10 years, the world's five largest companies by market capitalization have all changed, save for one software company. Now they are all technology driven companies, each dominating its industry corner, be it for example search, social media or e-tailing. Three are, in classic economic terms, monopolies. How long will it be before governments and regulators start taking a keener, actionable interest?

What happens when something bad happens?

WL: Events happen. What matters to us is how they're dealt with.

Recently, one of our investments revealed staff misconduct at a senior level. The issue quickly became headline news. The board reacted responsibly and swiftly in our view, bringing in external counsel with a mandate to act with free rein, resulting in the departure of several key anchor presenters. No exceptions, no excuses. Another investment experienced product safety issues in its South Korean market. The company took immediate responsibility for the event and created a compensation plan for those affected. They reviewed and changed their product safety, quality and compliance structure, raising the role to board level, reporting to the Chief Executive. Absorbing the lessons from the event, the executive compensation committee withheld the Chief Executive's annual bonus on account of the South Korean experience.

Both companies serve as examples of what we like to see; doing the right thing, responding quickly and decisively, and setting the course for change.

Do you use ESG research providers to help with analysis and ratings?

WL: We have access to third-party ESG research and reports, which we can use to help identify or assess the relevant ESG concerns that could undermine the long-term sustainability of a company's returns.

As for the ratings, we take these with a pinch of salt because ESG research providers offer company ratings in a relative way, through a score. To us, as bottom-up investors with a focus on the fundamentals, these scores can be misleading, if not risky. For example, we believe it makes little sense to apply a sector-relative argument for governance; governance is governance is governance. It doesn't matter who you are or what you do—the same standards apply. In our view, basing investment decisions on a relative ESG scoring methodology could invite unintended environmental, social or governance risks.

For what it's worth, our portfolios tend to score well relative to the benchmark on independent ESG scores.

ESG integration is a buzz-word at the moment. How do you see the next five years given its rising profile?

WL: It's a force for good. Companies and investors are increasingly recognizing the value of high standards of governance, and the impact that operations, products and services can have on environmental and social areas. But I continue to maintain that if a company hasn't got its governance in order, then it is probably less likely to have the structures and motivation in place to develop and improve its environmental and social impact. And without this, the sustainability of a company's returns will be in question.

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