The True Meaning of Sustainable Investing

Disruptive Forces in Investing **April 25, 2023**

Anu Rajakumar: Over the past decade, interest in sustainable investing has skyrocketed. At the end of 2020, the Global Sustainable Investment Alliance estimated that global sustainable assets had reached $35.5 trillion. But sustainable investing is not a new phenomenon. It draws on a very long history of socially responsible investing, particularly from faith-based investors dating back to the 1600s. Neuberger Berman's Sustainable Equity Strategy, which was among the first of its kind, was launched back in 1989. And over the last 30-plus years, this space has evolved considerably.

So how does sustainable investors apply this approach in today's investment landscape. What should a due diligence process look like? And finally what are the benefits of an active and engaged approach? My name is Anu Rajkumar, and today, I welcome to the show, Daniel Hanson, Senior Portfolio Manager for Neuberger Berman Sustainable Equity team, to discuss his approach to long-term sustainable investing. Dan, thank you for joining me today.

Daniel Hanson: Thanks, Anu. Great to be here.

Anu: Now Dan, for some folks, sustainable investing may be a newer concept, but as I alluded to in my intro, it has been around for a very long time. Why don't we start by talking about some of the history of socially responsible investing?

Dan: Sure Anu. Sustainable investing has been around for hundreds of years. The labels change. There's this great enthusiasm currently [with] people using the ESG label. There's been some backlash to that, but broadly, this has been a component of investing since the origins of capitalism in 1600. In those early capitalist joint stock ventures, there were some profits that came from piracy. There were some Mennonite investors who said, "Keep those pieces of the profits. We don't want blood money."

That's in my mind, the origins of what we now call sustainable investing. For hundreds of years, particularly religious groups, the Quakers in the 1700-1800s, would align their values and not participate in businesses that use noxious chemicals, tanning of leather for example. So there is a long heritage. In the US, that really gathered steam with the anti-apartheid activities, the Sullivan Principles in the late '70s. And then you saw divestment, it happened with General Motors and Coca-Cola, et cetera, in the early '80s.

That certainly bought great attention to what we now call sustainable investing. At the time, we called it socially responsible investing. You know, another big marker I think was the formation of the Council of Institutional Investors, the CII, which came together in response to the Milken financed LBO era.

So these are some of the markers [over] time. And then in 2006, the PRI was formed largely with the impetus of large, [long-term] multi-generational pension fund asset owners. So the current enthusiasm and in some cases controversy around what's being called ESG investing is really part of a long, long heritage of serving asset owner's interests.

Anu: Great Dan, that was very helpful. I understand you are a veteran when it comes to sustainable investing. I'd love for you just to take a minute or two, just talk a little bit about your background in this space. How did you get into sustainable investing?

Dan: As an investor I'm looking to drive positive returns for my shareholders and I deeply believe in the empirical drivers of cash flow and value that's a part of shareholder value. I had some clients asking to run mandates specifically in what at the time in 2006 was called socially responsible investing. And in solving for those clients who wanted to align their values and business ethics, in a sense of "take the high road" so to speak.

A light bulb went off in my analysis, that solving for that client need was exactly what I was trying to solve for in looking for what I call high-quality compounding businesses. I look for businesses that grow the pie for their customers, where they don't view business as a zero-sum game. I look for businesses that embrace the relevance of stakeholders, serving the customer, so the customer wants to come back. [Businesses] treating employees well, so the employees want to work for this business and it can be a best-in-class employer. And I come through the lens of this is a flywheel to identify high-quality compounders, and I can at the same time be a hard-nosed investor looking to drive best-in-class financial returns for my shareholders.

So then having been on this journey for a number of years, in 2011 I was part of the founding board of directors of something called the SASB, the Sustainable Accounting Standards Board, which has really helped to try and drive further this idea of better data can drive better decision making and better understanding of the business. And so we've come a long way but I think we still have a long way to go.

Anu: Wonderful. That's great. So you've spoken a little bit about using environmental, social, and governance factors as part of your expanded toolkit. Tell us about your investment philosophy. How do you summarize what you're looking for within the sustainable equity universe?

Dan: Sure. I think the key point of distinction that I've developed over multiple decades and market cycles, is looking through the lens of the stakeholder and viewing again business not as, it doesn't necessarily need to be a zero-sum game. That lends itself to certain business models. Not all business models. But it's really a process looking for, "Hey if I want an outcome of great high-quality compounders, what [is] the ingredient set?"

First of all you've got to have profitable growth. You've got to have unit growth. You've got to be responding to an unmet market need, doing it in a differentiated way. People talk about a moat and that's a classic financial investor framework to identify a sustainable competitive advantage that drives pricing power. Certain businesses lend them themselves to that. And that's really just your classic hard-nosed financial analysis.

But then I bring a long-term ownership view that takes a deep look at culture, management, what's the purpose of this business? Almost a private owner [mindset] of a long-term investor. Other investors do that, but I think we take a particularly deep, long view. And that's an advantage when you come to public markets with that discipline. But then the third I think aspect, which is somewhat differentiated, is using this lens of environmental and social and governance kind of issues.

In some cases, you may have a very adversarial relationship where the customer would love to leave you, but there [are] high switching costs. There's [a] regulatory capture. There are different reasons. Now that may be a good economic business, but if fundamentally the customer doesn't want to do business, I would consider that a point of concern.

What I love to see is businesses where the customer benefits, maybe it's through enhanced productivity, enhanced ability to serve their end customer. And so that can be a positive flywheel. And looking into that lens of stakeholders identifies, "Hey, the customer maybe is a materially advantaged piece of this business model." In other businesses, maybe it's the employee engagement. You know, we've seen with the economic environment how it is, it's tough to retain talent and keep the best employees. So to have that cache of a favored best-in-class employer, that translates to real value for us as shareholders.

So looking through that lens of what's the culture and practice and evidence. So we look at statistics, some of that shows up in what we would call the S of ESG, the social lens. And it goes beyond just disclosure, EEO1, et cetera, data can help us get a grasp of it. But ultimately taking a deep view and in some cases, businesses who are favored employers of choice, that translates to an advantage to the customer. It can be a flywheel for the business that ultimately absolutely shows up as profits for the shareholder.

Other issues of social license to operate, whether that's a more general thing like the concept of NIMBY, “not in my backyard,” if you as an employer or as a business are not welcome in an area, if there's an adversarial aspect, that's something that as a shareholder we take a close look at. All things equal, we want an employer that is welcomed operating in its community that's seen as providing skilled employment opportunities, economic growth for a region, operating in a high caliber way. These are all things that we believe, it's just part and parcel of robust fundamental analysis to identify great long-term enduring business models. And so that's our version of bringing sustainability to life as long-term fundamental investors.

Anu: Yep. Sure. Now Dan, I'm curious, the framework that you just described, does it lend itself, in that you end up biased towards any particular sectors or industries? Bias, like to or for, just how do you think about that from a sector perspective?

Dan: Yes, we do feel like the world is our oyster. We want to outperform over multiple market cycles, over the long haul. And so a diversified breadth of business models can fit with that objective. Valuation matters a lot. Really, high-caliber businesses tend to be expensive, and so that may diminish the return prospects. So we keep a very broad purview.

Having said that, all things equal, we're looking for less cyclical, high sustained return on invested capital, for example, so that we would tend to shy away from more asset-intensive commodity-like businesses. Commodity business may be run ethically, may be a great employer and on the list. But the essence of a commodity business definitionally is a zero-sum game. So we look for value-added businesses where there's some secret sauce and knowhow, whether it's through culture, it's intellectual property, maybe an engineering competence or longevity of relationship. We tend to be biased towards more asset-light businesses, higher elevated less cyclical profit streams. So in general the fishing pond, where we find those businesses, leave us looking in higher growth less asset-intensive businesses.

Anu: Terrific. You know, Dan, everything that you've said so far really lends itself to active investing. I want to dig into this topic a little bit more because it is a hot topic for so many. How do you see active versus passive within sustainable investing?

Dan: Oh, we very much view sustainable investing as intrinsically active. That fundamental analysis of digging deep, understanding the nuances, the concept, the materiality, what are the needle movers? What are the important issues? The discipline of quantitative analysis, looking at many key performance indicators (KPIs) and you know, we've got a litany of scorecards of ESG markers as a part of our process just as we have a litany of classic financial metrics as part of our process.

But looking at a price-to-book metric without an understanding of what's in the book value can get you into trouble as an investor. And so we just view it as an extension of good fundamental analysis. Again, in the accounting discipline, we don't take earnings at face value. GAAP earnings can reflect a whole range of management aggressiveness. Maybe they've got an aggressive attitude about loading up their docks at quarter end to make the sales number.

A short-term attitude can show up in aggressive accounting metrics, for example. Whereas another company in the same industry today that has a more conservative accounting posture, the numbers are going to look different. As investors, we want to understand the difference in the qualitative nature. And we bring that same spirit to sustainability. So we think there's a necessary fundamental acumen in digging through all the drivers of returns, and absolutely that's true in the realm of environmental and social and governance issues.

Anu: Excellent. You know another element of active investing, particularly in this space, is just engagement with companies. I'd like to dig into that a little bit. I understand that engagement is a core element of your philosophy. So Dan, how do you ensure that your clients have a voice?

Dan: We are long-term investors and really act as a share owner. So there's been, I think, increased market awareness of the role of engagement and stewardship which is a positive broadly. But our approach has always been to act as a long-term owner. We're ideally identifying businesses where we expect to be a multi-year holder, and as such, we are a shareholder, we have a voice. And so it's a part of our fiduciary duty to act as an owner that shows up specifically during proxy season.

Right now, we're in the midst of a busy proxy season, but given our long-term investment horizon, [our engagement approach] spans multiple years. So I could give you an example of an area we've engaged for multiple years is on science-based targets around climate. So today climate awareness and disclosure and corporates wishing to demonstrate that they're part of the solution, not part of the problem, has become a very widespread mainstream component of a high-quality business model.

I think we were early to encourage our portfolio holdings to take that proactive attitude. So we've been part of the Carbon Disclosure Project, the CDP, for many years. Then more recently in 2018, we began specifically reaching out to all of our holdings, encouraging the value of science-based targets disclosure and adoption of targets as a means to communicate to the market, "Hey, we're committed to leadership and we're holding our organization to account."

So that's an example where for more than five years we've been having an ongoing dialogue and we've seen a number of our portfolio holdings demonstrate to the market that they've got commitments and we've seen that become a very widespread mainstream tool for managers to communicate. More broadly our approach around engagement leans heavily on communication and disclosure. So we don't take a prescriptive approach saying, management should do X, Y, or Z, but rather we encourage best practices.

We encourage disclosure so that the market can recognize leaders and conversely can hold laggards to account. But we're fishing in the pond of who we think intrinsically are leaders by engaging and getting the word out, frankly that's good for shareholders.

Anu: So now, Dan, when you are engaging with these companies and encouraging them to follow science-based targets, for example, what is the reception like? Are they typically open to your feedback or do you ever find that there is some pushback that the companies are giving you?

Dan: It's the whole gamut. There's absolutely an aspect of pushback, particularly if it's an emerging issue. So in 2018, science-based target adoption was not widespread. So we did get some initial pushback, but then had a great experience with some multiyear holdings that are still in the portfolio, where ultimately management came back to us and complimented our putting issue on the map and advocating, and they saw the value. And ultimately we've seen a number of these companies publicly disclose that they've got validated targets. So there's always emerging issues, kind of where the puck’s going. That goes back to your earlier question about, can you do this in a passive way versus the role of fundamental active investing.

And there is absolute value to metrics and disciplines, and rules-based approaches can help to bring some discipline. Our attitude is that as fundamental investors, that gets us maybe to the 50-yard line, maybe gets us a head start, but ultimately it's forward-looking and engagement is an example where emerging issues that we view are going to be very material in the future, they're not yet showing up on any kind of a third-party scorecard or any kind of consensus playbook.

You know one [issue] right now top of mind is around ethical use of technology. And whether that's social media and you're seeing hearings in front of Congress on a regular basis, you're seeing in various state legislature bans being proposed, et cetera, that's an issue that's going to be long lived. So any businesses that are operating in that space, they need to be on top of that. Artificial Intelligence, AI, there's heightened scrutiny right now around, gosh, what is, what sort of Pandora's box is being unleashed.

So those are examples of the emerging issues. While we'll engage with companies that have a footprint in these areas and encourage transparency and leadership and visibility around governance practices, to again go to where the puck's going, so to speak.

Anu: Sure, absolutely. And just on that point, I'll give a shameless plug to our previous episode on ChatGPT and sort of how that's going to affect the financial services industry, but likely going to affect almost every major business out there.

So as we start to wrap up here, I want to get some of your views on the future of sustainable investing. We address that there's been huge growth in this space over the last few years, but also some challenges, more recent controversies, particularly politicization in the US around ESG and sustainable investing. With all that said, what are you looking forward to over the next few years for the sustainable investing space?

Dan: Yes, I'm excited about the maturing of this space. A better understanding and appreciation for, on the one hand, the positive aspects of sustainability and the value that ESG analysis can bring to any number of investment approaches. Having said that, right now, there is a lot of scrutiny. I think some of it is deserved and we can have a bit of a shakeout and a better understanding of quality and what are various investment approaches trying to solve for.

Now, this is not unique to ESG, there are myriad approaches to investing and there's a range of caliber of approach. Ultimately, investment excellence is what clients should expect. Again, I think the caliber of the discussion around ESG, around stewardship, around I think the intrinsic importance of a fundamental active perspective and a forward view, we view that as integral. So look, in summary, our approach to sustainable investing embraces the view that we want to identify high quality enduring businesses. It drives shareholder returns and we see it as absolutely additive to the bottom line.

Anu: Excellent. Thank you very much. Now Dan, every guest that comes on the show gets a quick bonus question. I noted from your biography that for a portion of your career you taught sustainable investing at the University of California Berkeley Haas School of Business. I'd love if you could just take a few seconds to reflect on that experience and maybe share a particular poignant memory or moment being a teacher.

Dan: It was eye-opening, having not been in the classroom for 25 years to be back in a classroom, and it was energizing in terms of the passion and intensity. It was also exciting to see the enthusiasm around ESG, a still relatively new field, on a business school campus where you've got a pretty hard-nosed group of individuals. But this generation is interested in the concept of impact, thinking beyond next week's paycheck and whatnot, about the broader societal impact, the role of business.

There are some changes and at times, I might come off as the grumpy old member of my generation. But the empowerment and the thoughtful perspective on, you know, every business makes an impact. It's just a matter, is it mindful? Is it intentional? And the enthusiasm that I think the next generation is bringing to the discussion.

Anu: Terrific. Thank you very much. Dan, really appreciate you joining me here today. I loved hearing a little bit more on your background and your light bulb moment that brought you to sustainable investing, as well as just broader comments about engagement and stewardship that you and your team bring to your particular portfolios. So once again, thank you for joining me.

Dan: Thank you, Anu.

Anu: And to our listeners, if you've enjoyed what you've heard today on Disruptive Forces, you can subscribe to the show via Apple Podcast, Google Podcasts, or Spotify, or you can visit our website, www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and offerings.