NOMURA ASSET MANAGEMENT U.K. LTD.

The Philosophical Thoughts of a Responsible Investment Team

The Global Equity Team

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Introduction

This thought piece delves deep into the topic of Environmental, Social and Governance (ESG) and Responsible Investing. We consider the associated logic and also the psychology. Rather than basing an argument on the belief that ESG will be an outperforming strategy, we conclude that it is **just the right thing to do** and you should **always start from there**.

We believe that responsible investing is the process of giving consideration to the total impact of the investee corporations on all stakeholders, not only the end investors (our clients) but also customers, suppliers, competitors, broader society, the environment and ourselves.

About Nomura Asset Management

The Nomura Asset Management Group is a leading global investment manager with over US$425 billion of assets under management. Headquartered in Tokyo, Nomura has additional investment offices throughout the world including London, Singapore, Malaysia, Hong Kong, Shanghai, Taipei, Frankfurt and New York. With a global workforce of over 1,300 employees it has been operating in Europe for over 30 years.

Today Nomura Asset Management provides its clients with a wide range of innovative investment strategies including global, regional and single country equities, high yield bonds, alternative investments and global fixed income strategies.

US$ **425** bn	**1,312**	**240**
assets under management globally	staff employed across 15 offices	portfolio managers located strategically around the world
109	**1959**	**30** years
dedicated professionals committed to fundamental and quantitative research	Our investment management capability was established in Japan over 50 years ago	Operating in Europe for over 30 years

Source: Nomura Asset Management as at 31st December 2018

Why incorporate ESG research at all?

The Logic

There is an increasing acceptance that investment decisions should be made in consideration of their long-term impact on the world, not just their near-term financial results. ESG and other non-financial factors are being assessed as part of overall investment processes, but although opinions on specific ESG issues are often hotly debated, the motivation for even having an opinion or taking action are less well explored.

Often "doing ESG" is touted as a route to generating superior investment returns, linking the ultimate success of a business to its sustainability. Leaving aside the validity of investment logic, the statement certainly has appeal. It clearly fits the simple and well accepted "Incentive Theory of Motivation", which suggests behaviour is motivated by incentives or the oft adulterated version that focuses on financial incentives. As Berkshire Hathaway's Charlie Munger says "Show me the incentive and I'll show you the outcome".

Although we do not necessarily disagree with the hypothesis that 'good ESG' companies should out-perform 'bad', it is healthy to question this Machiavellian motivational logic. Certainly good corporate governance or high standards of operational and product safety for example should, intuitively, lead to good investment returns and Nomura Asset Management's own back-test data suggests this might well be the case.

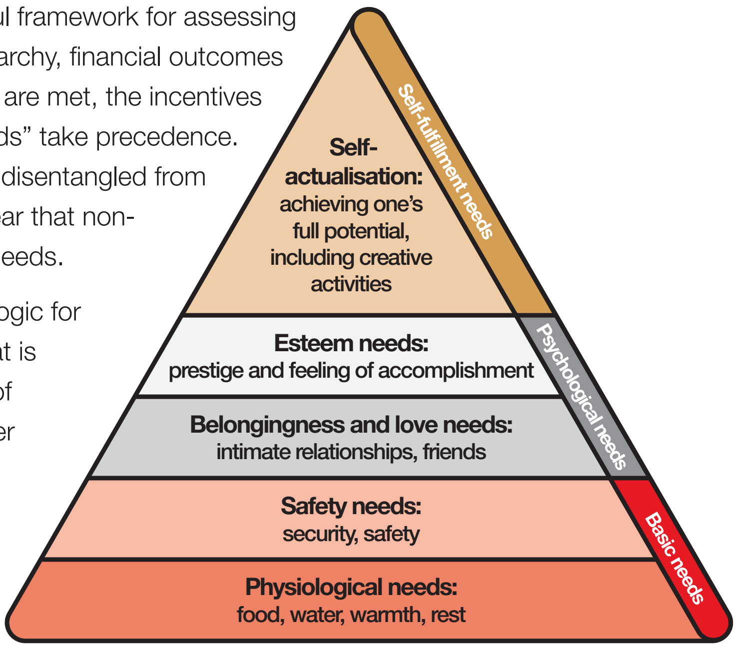
> ***"What if ESG does not enhance investment returns?"***

However, this clearly does not apply in every case and ESG may actually turn out not to have such significance for investment performance or even its efficacy may reduce over time. Given that back-testing is fraught and that capital markets tend to erode the efficacy of well-defined sources of excess investment return over time, if not true already, 'ESG' having limited impact on investment returns may plausibly become true in the future. If this is the case then financial logic would presumably argue for the removal of ESG considerations from the investment process. To us this does not seem the responsible response.

The Psychology

Maslow's "Hierarchy of Needs" is a well-known and useful framework for assessing the relative importance of motivational factors. In the hierarchy, financial outcomes serve predominantly to meet "Basic needs". Once these are met, the incentives relating to "Psychological needs" and "Self-fulfilment needs" take precedence. Of course, for many, financial incentives cannot easily be disentangled from the feelings of accomplishment and fulfilment, but it is clear that non-financial factors are the main driver of the 'higher order' needs.

Hence, in the Hierarchy of Needs we find a motivational logic for incorporating ESG matters into investment processes that is quite apart from, and arguably more powerful than, that of financial incentives. Whether 'ESG' has efficacy as a driver of investment returns or not is irrelevant to its efficacy as a fulfiller of 'higher order needs' such as contribution to family/community, respect of and by others, accomplishment, the achievement of one's potential, creativity, etc.



"It's just the right thing to do"

Thus, at Nomura Asset Management UK we find a simple answer to the question of what to do should we conclude that ESG has no significance to investment results. Firstly, we believe our investment analysis and stock-specific decision making will continue to deliver superior investment returns, not the simple exposure to certain investment 'factors', be it "Growth", "Value" or "Good ESG". Secondly, we believe our ESG related activity offers a contribution to meeting the 'higher order needs' of our clients and ourselves. In short, this work is just the **"right thing to do"**, not simply as a means to an end and so should continue unchanged.

So if there are strong motivations for incorporating ESG considerations into the investment process, what is an appropriate approach for doing so? Often ESG decisions are governed by a framework that simply dictates allowable and non-allowable investments (a 'screening' approach). We propose, however, a different analytical framework for responsible investing based on key considerations for the betterment of all stakeholders.

Utility Theory

Jeremy Benthem, the nineteenth century philosopher proposed that to measure the rightness or wrongness of a decision depends on the outcome bringing the "greatest happiness of the greatest number". This is the underlying principle of utilitarianism and we have applied this to the challenge of investing responsibly. In other words, to judge what we should and should not invest in, we must assess the wider utility derived from our investment decision.

For example, we might apply this framework to a possible investment in a business that uses monopolistic pricing power to hike lifesaving drug prices more than 50x, to almost entirely unaffordable levels. The stakeholders in this decision clearly include the end investors (our clients) and the customers who need the drug. The end investors may wish for high investment returns and would thus be happy with such corporate behaviour, but what about the severely detrimental impact on the customers?

Consideration of these stakeholders leads us to conclude that the total utility would not be enhanced by the investment and therefore we should not invest. This is our view. Or put another way we should not make investment decisions that cause an overall reduction in utility to all stakeholders including, but not limited to, shareholders. So it follows that we should invest in companies, and make investment decisions, that increase the utility to stakeholders at large.

We believe that considering all such stakeholders is the mark of a truly responsible investor and so we conclude:

Responsible investing is the process of giving consideration to the total impact of the investee corporations on all stakeholders, not only the end investors (our clients) but also customers, suppliers, competitors, broader society, the environment and ourselves.

Our starting point, as responsible investors, therefore is to think about the total utility or total value created by our investee or potential investee companies. The total value created is not just financial but the benefit delivered to all stakeholders, including the happiness brought to customers, the employment and growth opportunities brought to employees, the impact on the environment, etc.

To achieve long-term returns for our clients we, of course, seek to invest in those companies that can sustainably create significant value. However, even if the total value creation is positive, sustainability cannot typically be achieved if the value created is not fairly shared among the various stakeholders. In our drug pricing example for instance, in the short-term, hiking prices allowed the company to dramatically increase its share of the value created by the drugs it produces, to the benefit of shareholders. But such price increases sparked a political and regulatory backlash that ultimately backfired on the industry. Dramatically increasing the price of drugs that have been in production for years did not create extra value in the broad sense, but did allow the company, for a short period, to capture a much larger share of the value that was being created already.

In similar fashion, unethical practices within pockets of the banking industry leading up to the global financial crisis in 2007-2008 meant banks and their employees were able to capture an unnaturally large share of the value created by those organisations, for a short period. Ultimately, however, there was a significantly negative impact on the banks themselves, all employees, customers, and not to mention shareholders. In this case, the disequilibrium in the distribution of the value created, between the different stakeholder groups, ultimately led to a complete overhaul of the industry and a regulatory burden that has transformed the return on capital that the banks can earn. Indeed we think it is further likely that companies which behave in the least ethical manner towards the environment and society will be the ones that disregard the interests of minority shareholders.

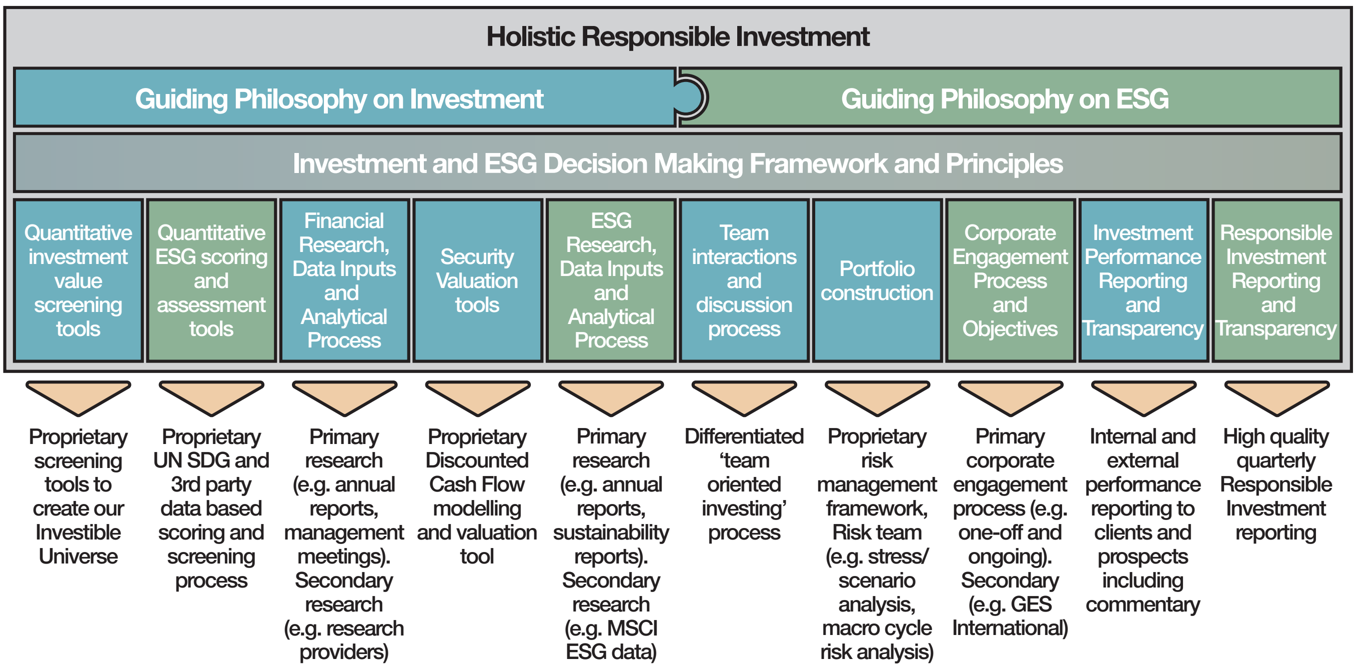
With this in mind we simply put it that, **in the long run, investment returns cannot be sustained without successfully balancing all stakeholder interests.**

However, implementation is not easy

As we have seen, consideration of ESG matters can contribute to meeting the ‘higher order’ needs for our clients and also ourselves, as investment professionals. It follows then that the people making the investment decisions should be the same ones who conduct the ESG analysis. Of course we must accept capacity or specialist knowledge limitations, but judicious use of third party data and research within a clear philosophical framework shared across an investment team can ensure ESG is fully integrated into the investment process. Having all the inputs in one place is a clear positive for decision making.

The proximity of investment analysis and decision making tends to produce better investment outcomes. Therefore, proximity of ESG related analysis and ESG decision making should similarly produce better ESG outcomes. Indeed, the combination of investment and ESG decision making could be considered the hallmark of a truly integrated Responsible Investment approach.

We have described above our guiding philosophy on ESG and our philosophy on investment generally can be summarised as “invest in decent quality companies when the shares are below intrinsic value”. The utilitarianism based framework described above and organisational proximity of decision inputs and decision making, on all matters, are some of the key principles for our investment operation. The figure below illustrates the interaction of all the components and practical tools and processes that can make the operation work cohesively and consistently.



Some consideration of the framework in the real world

We previously looked at examples of ESG related failings and their consequences and they were relatively clear cut. History suggests, however, that there is a broad band within which a company can operate where all stakeholders are satisfied ‘just enough’ by their share of the total value creation, even though the impact on certain stakeholders might be far from optimal. Movement outside of that ‘fair share band’ tends to lead to a sharp correcting force, bringing the value share back to a fair or equilibrium level.

Put differently, companies can continue to generate sustainable long-term returns despite certain stakeholder groups being negatively impacted by the company’s operations, especially where the stakeholder has no strong advocate. This is an example of where we believe our corporate engagement activity can make an active and positive impact on corporate behaviour.

Different groups acting as advocates for different stakeholders will undoubtedly lead to the stakeholders of the decision making group seeing their perspective brought to the fore, irrespective of any stated Responsible Investment philosophy. So the proximity of decision making and decision inputs is particularly useful in handling nuanced scenarios, plotting a course for improvement and then actively engaging to promote that course. However we, the investment professionals, are clearly stakeholders and also are the decision makers, so could our own ethical position, inadvertently, carry too much weight. Indeed should personal ethics and feelings toward the actions of the company have an impact on the investment decision making process? And if our feelings are relevant then how should we weigh the impact on different stakeholders and make an assessment of whether this balance is adequate for us to invest in the company?

An example might be the decision as to whether to invest in a company that is expected to outperform versus a peer, but clearly has a greater impact on the environment through higher CO_2 emissions and looser internal policies. Many of us believe strongly in limiting our personal impact on the environment, but when it comes to our investment decisions how should this be incorporated in the decision, if at all and, in any case, what is the relative importance of the environment and broader society compared to attractive investment returns?

Utilitarianism, including ourselves in the stakeholder group can help. In essence we can prioritise the different stakeholder groups and then assess the negative or positive impact that our investment decision (for example in environmentally damaging companies) would have on each stakeholder group. Then, in theory, a simple priority weighted average of the stakeholder impacts should tell us whether, in aggregate, we should or shouldn’t make the investment. However as Yogi Berra once said, “In theory there is no difference between theory and practice. In practice there is.” There is often no clear cut answer as to the impact on different stakeholder groups, and personal ethics clearly vary from person to person. Moreover we need to consider the issue of ‘moral relativism’, that is an ethical action from one perspective might seem unethical from another perspective. This is where our personal ethics can help and whilst we cannot apply the ethics of someone else, we can add a broader ethical viewpoint in an investment decision making context.

What are we really responsible for?

Taking a step back, however, the question becomes: what is the point of our role within capital markets? The answer here is that, as long-term investors, we are partial owners of businesses and, as partial owners, we must consider ourselves responsible for their actions. To not do so would, surely, make us irresponsible investors. As owners of businesses we want the value to increase in the long-term and collectively as investors we have a responsibility to promote actions that support this rather than focusing on short-term profits and share prices.

By supporting companies that contribute excessively to global emissions, and show very little regard for addressing the issue, an investor may individually be able to generate strong returns. However, in the end, such disregard for the company’s actions is not sustainable because severe climate change could detrimentally impact value creation through the very negative impact on most supply chains and end markets globally. Such an impact on value creation would certainly impact investment returns.

The decision making process of the responsible investor must therefore involve a stakeholder impact analysis, of the investee company, and an assessment of the investor's willingness to accept responsibility for those impacts. Of course, we are not employed to be the guardians of international equality and nor should we attempt to be global 'eco-warriors', but it would be irresponsible not to take into consideration such sustainability factors in making balanced, long-term investment decisions. Our primary focus must be to generate attractive returns for our clients, but we must be 'responsible' in doing so. This does not mean that we will never own a coal fired power generation company, for example, but we will actively assess the positive or negative impact on the broader stakeholder group of such an investment. Moreover as responsible owners we should actively engage with management where necessary to push for better practices and encourage taking a long-term sustainable approach to the treatment of all stakeholders.

Our practical steps

At Nomura Asset Management UK we integrate ESG research into our investment decision making process and actively engage with potential and actual investee companies. We use dedicated external ESG and NGO research, to supplement our own fundamental analysis and actively seek to understand the impact that a business has on all stakeholders, so as to make balanced comparisons and ultimately responsible investment decisions. Where necessary we use our influence to push for better practices that more fairly treat all stakeholders, and these efforts are published in our Quarterly Responsible Investing Reports. We recognise however that we can always do more, and we expect to see the importance of responsible investing grow over time. This thought piece represents not only what we do today, but the continuing evolution of our thoughts as responsible investors and where we might improve.

As an example of the ever growing importance of responsible investing, NGOs are increasingly aware that investors can help address environmental and social issues. In March 2016, the Rainforest Action Network (RAN) hand delivered a report to every participant of an investor conference in New York City. A US clothing retailer was one of the companies presenting to investors at this conference, and RAN claimed that almost 300 of the products the aforementioned retailer sold contained fabrics derived from wood coming from the destruction of Indonesian rainforests. The company did not issue a rebuttal to this report, and we took the decision to follow up with the company to express our concerns and enquire as to whether the RAN findings were true. When the CFO subsequently visited our offices, we questioned her on any progress made so far. The company has since engaged 'constructively' with RAN but we continue to encourage the company to act swiftly to clean up its supply chain.

Disclosures

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