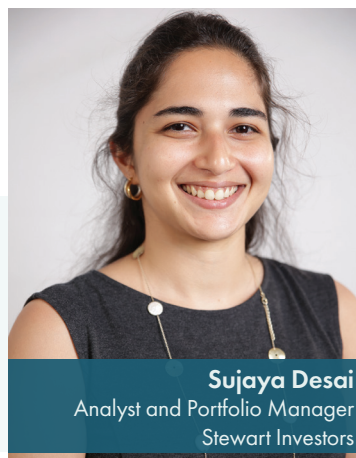


DELIVERING RETURNS THROUGH STEWARDSHIP



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As ESG investing has taken center stage, institutional investors have focused largely on the environmental aspects of net-zero mandates and renewable energy technologies. But the social and governance aspects are moving to the forefront as well, offering a variety of approaches for investment portfolios.

For Stewart Investors, the core differentiator is a consistent commitment to governance through stewardship. Stewardship — which it defines as managing a business for the long term while treating all its stakeholders fairly — has formed the basis of its investment strategy since 2005, when the firm launched its first sustainability fund.

“In those days, ESG investing was not as prevalent as it is now, and investors rarely asked about sustainability considerations,” said Sashi Reddy, analyst and portfolio manager at Stewart Investors. Today, in contrast, the focus on sustainable outcomes can sometimes be greater than it is on returns. “However, we believe they are two sides of the same coin,” he said. For Stewart Investors, the spotlight on sustainability concerns and opportunities was simply an outcome of a philosophy focused on long-termism. The firm pursues “a highly investment-driven approach that integrates sustainability, which has been an excellent way to manage risk and drive returns over the past 18 years.”

While Stewart’s core principles on stewardship have not changed, the firm has refined its ideas on good stewardship and what it means for its investment thesis. “We continuously challenge ourselves to identify high-quality businesses for our portfolios,” said Sujaya Desai, analyst and portfolio manager at the firm. Today, its evaluation of companies centers on the people running the business, the resilience of the franchise, the strength of the financials and the sustainability positioning of the company. “We look for management teams who intend to, and have the ability to, leave a business in much better shape than when they found it,” she said.

FIVE PILLARS

Stewart’s investment philosophy is built on five core pillars: long-termism, an absolute-return mindset, a bottom-up approach, quality and sustainability, said Reddy. “We look at least 10 years out when we make an investment; we are focused on absolute returns; we start with a blank sheet of paper and try to find a short list of investible ideas; we seek out people who build businesses and cultures that can thrive across business and economic cycles; and we believe that integrating sustainability considerations minimizes risk and enhances returns.”

From Stewart Investors’ perspective, governance and sustainability are intertwined. “Over 30 years of looking at companies globally, we have found that corporate stewards who are committed to building their businesses for the long term are also thinking about protecting against sustainability risks and benefiting from the tailwinds of change,” Desai said.

A key challenge for institutional investors has been to adopt appropriate sustainability metrics that impact investment outcomes. Stewart Investors has outlined a well-defined approach to stewardship within its bottom-up stock selection, which starts with the personality traits of a company’s lead-

ership. “We look for three main characteristics: competence, humility and integrity,” said Reddy.

“For long-term investors like ourselves, humility is also important. Companies are run by people and people make mistakes. A culture of humility means mistakes will be acknowledged and fixed quickly, potentially saving the company time and money in the future,” he said.

“When we look at a company, we go back into its history as far as possible because we can uncover many clues. We look at points of crisis to understand how people behave when things are not going well. That’s the best evidence you can get for character and leadership,” Reddy explained.

BUSINESS IMPACTS

Community involvement is another aspect of a sustainable mindset, and one that Stewart takes seriously. “One of our recent engagements that brought up the issue of local communities was related to plastic packaging by consumer goods companies,” Reddy said. These companies are well positioned for long-term sustainability through the many ways they contribute to health and hygiene around the world. “However, one of the negative repercussions for these firms is the quantity of plastic waste that they’ve produced over the decades,” he said.

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“We have engaged with a number of Indian consumer goods companies over plastic-waste production and recyclability and encouraged them to reduce the amount of plastic content in their packaging,” Reddy said. As regulation around plastic packaging is expected to tighten, it creates business risks that can directly impact future profit and loss statements, so consumer goods companies need to make these changes now, he pointed out. “We’re not engaging on something that’s simply ‘nice to have.’”

IDENTIFY A NORTH STAR

Stewart Investors resists the notion of a cookie-cutter approach to sustainability. “We don’t think it’s possible to build a business with a perfect formula,” said Desai.

Yet, across the many companies that the firm has evaluated, it has found common stewardship-related traits that boost outcomes. These successful companies “build cultures that are quite unique, with a consistent focus on operational excellence. Their key challenge is to act consistently over time, overcoming any short-term pressures they may face,” she said. The dedication to stay the course is really what differ-

entiates the best companies from the rest. “It’s almost like a North Star that guides the path for the company.”

Costco is one example. “A unique corporate trait, alongside their differentiated membership-based business model, is how Costco treats its employees versus the retail industry standard. While some retailers post staff turnover numbers north of 50%, Costco’s is closer to 14%, Desai noted. “They have achieved this by ensuring higher wages and better benefits for their employees, which enables them to attract talent, provide better customer service and have lower expenses for staff training.” In Stewart’s view, this isn’t just altruism, it’s good business sense.

Another example is Watsco, the largest U.S. distributor of heating, ventilation and air-conditioning equipment. The company’s controlling shareholder acquired his stake when he was 32. “He spent his entire life building this company with a combination of patience, discipline and decentralization,” Desai said. Watsco has evolved steadily over the past three decades by consolidating a fragmented distribution market, acting as one of the most trusted partners to original equipment manufacturer suppliers and providing high-quality products to a fragmented network of contractors.

QUEST FOR QUALITY

Each company can pursue different aspects of long-term stewardship that fit together. “These are what we use to tie the elements together to build a picture of high quality. One of the largest pieces in that picture is the quality of both people and stewardship. In a world that’s increasingly focused on the short term, finding a firm that takes a long-term view is one of the best signs we have of a company that’s charting a very different course [from] the rest of their peers,” Desai said.

Watsco, for instance, is focused on cash generation and maintains a healthy balance sheet to weather macroeconomic storms that are buffeting a consolidating industry, she said. “We saw evidence of this in 2008. When many firms were battenning down the hatches, Watsco was well placed to complete several acquisitions, and they emerged even stronger after the Global Financial Crisis.” Today, Watsco is “benefiting from sustainability tailwinds, as more heating and cooling products must be replaced to ensure energy efficiency,” Desai said.

As investors around the world assess the current sustainability landscape, they may come back to the question, Can you really do well by doing good? For Stewart Investors, the answer is clear. “We search for management teams who are building businesses that will thrive for decades to come. This is not a charitable trade-off,” Reddy said. “This approach has worked well for Stewart over the last 30 years across economic cycles, and we believe this should continue helping us deliver strong returns for our clients long into the future.” ■

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