INTERVIEW

PRINCIPLES-BASED RED LINES FOR AN IN-DEPTH TRANSITIONING INVESTOR DIALOGUE

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Victoria joined Newton in 2015 and is a responsible investment analyst within the responsible investment team. Victoria undertakes research and engagement on ESG issues with global companies, as well as voting and reporting to clients. She leads Newton's work on climate change and represents the company on the Climate Action 100+ resolution sub-advisory group.

She has previously sat on a number of investor-related advisory bodies including 30% Club Investor Group, UK Sustainable Investment and Finance Association Analyst Committee and the QCA Corporate Governance Expert Group. Prior to joining Newton, Victoria worked for Hermes Equity Ownership Services, the FTSE Group and CCLA Investment Management. She has an International Business BSc from Manchester University and an Environmental Technology MSc from Imperial College.

Newton Investment Management is a global investment management firm, founded in 1978 and owned by BNY Mellon. As of 30 September 2019, Newton manages £50.4 billion (€57 billion) of assets for clients based around the world, including public and private-sector pension funds, corporates and charities and, via their parent company, individuals. Newton is a thematic investor, whose global investment themes identify key, long-term forces of structural change which frame research and debate. Newton's investment team undertakes proprietary global research via its career global analysts and dedicated responsible investment team, to create an integrated investment process. These analysts join 66 investment professionals, who have an average 18 years' industry experience and work as part of one, single investment team.

Q1. Could you present Newton IM's principles-based 'red lines' that are used to identify companies unsuitable from a sustainability perspective?

For our range of sustainable funds, we wanted to ensure that companies adhering to the principles of good business were included in the investment universe. As such, we wanted to go with principles-based red lines, rather than traditional, ethical restrictions, which for many people can be off-putting, to enable this as a first step. The first red line excludes tobacco stocks, (the only hard exclusion we make), and the second removes companies violating the UN Global Compact Principles. As climate change is a critical issue that investors must take action on, we wanted to ensure a focus on heavy emitters, so created a final red line related to climate change. For the latter, we felt that a principles-based approach better captures the nuances of business operations. For example, through excluding gas producers you could also end up excluding utilities who are making big strides in renewable energy.

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Q2. So, you differentiate between fossil fuels, especially gas *versus* other fossil fuels?

While we can say that it is very unlikely that our sustainable strategies will invest in companies extracting coal, oil and tar sands, and at present they do not, we cannot say that they will never invest in a company that extracts gas. This is because there are some companies which are providing solutions to climate change, but are also involved in gas extraction. One example of this is Centrica, which is not a typical electricity generator but is primarily a UK energy service provider. It is making great strides in improving its carbon footprint and is playing a crucial role in decarbonising the UK's heat and electricity grid. However, to ensure a secure gas supply, it also has gas fields in the North Sea. A strict fossil-fuel exclusion policy would make this company uninvestable; however, we believe this would be a mistake. This is why we have a more nuanced approach to analysing fossil fuels, as there are potential positive investments on the fringes that can be inadvertently excluded by hard policies.

Q3. How do you define companies that are incompatible with a 2°C trajectory?

In our strategy, companies that are heavy emitters, which would be unprofitable under a certain carbon pricing, and which have no current intention of transitioning, are not investable. Our sustainable fund range has three processes: 1. Our initial red line screen, 2. The ESG team analysis and 3. Engagement with specific timelines. To do our climate change analysis, we analyse global companies that have been determined as heavy emitters by the IEA, and whose internalised cost of carbon at $140/CO2 tonne produces a negative net income. The $140/CO2 tonne is taken from the IEA World Energy Outlook, which under a 450ppm scenario would see heavy emitting sectors pay $140/C02 tonne by 2040.

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Q4. An increasing number of companies are setting medium and long-term decarbonisation targets. However, such targets should not be taken for granted but rather, be critically analysed, in terms of ambition level, effort requirements, and likelihood of success. How do you assess that?

For credibility and feasibility, we rely on a range of our service providers/data points to give an assessment on the quality of a company's emissions reduction targets and overall climate change policy. However, the preparedness of an actor can also be very hard to assess from a hard/data metric approach, so when we do our ESG analysis, we also go through a company's reports and take a view on how active they are being.

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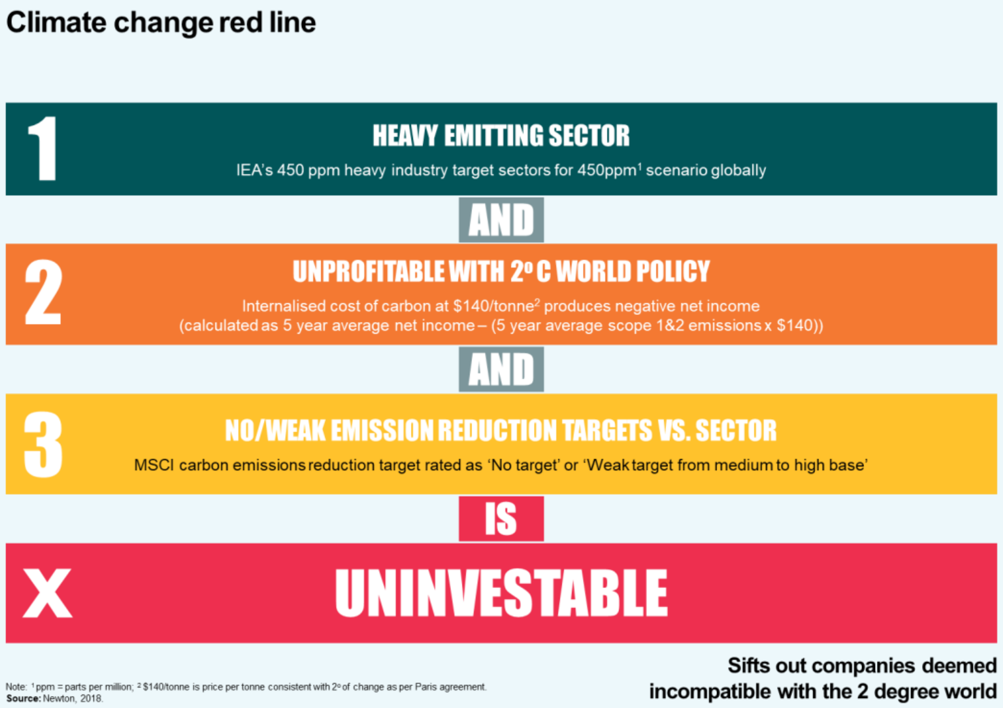

Illustration of Newton Investment Management's climate change red line process
Source: Newton Investment Management

Q5. What is the impact of those red-lines upon your investment universe? Were there some loopholes in your approach? How do you complement it with additional criteria?

Under this red line, around 9% of companies from the MSCI AC World Index are currently excluded, including various energy and mining companies, as well as certain airlines and utilities. When we first followed this approach, it threw up some unexpected results, e.g. Tesla would not have been investable for our sustainable fund range as its profits have not been large enough to weather this carbon cost. However, Tesla and other companies producing new technologies are the type of companies the fund range should be able to invest in, so we also now analyse the strength and ambition of a company's emissions reduction targets. To do this, we look at a company's activities/investments in renewable energy, energy consumption and operational efficiencies, as well as its CDP disclosure.

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Q6. If a company passed the red lines, what is next in your ESG analysis?

After considering whether or not a potential investment crosses one of our red lines, we then apply our ESG integration process to ensure that unsustainable companies have not been overlooked. This will depend on the company and sector. We analyse many data points, including a company's scope 1 and 2 emissions on an absolute and intensity-level

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basis, and how a business compares to its peers. Data analysed will include: TPI, CDP, SBT, Bloomberg data, a company's own data, and that of our ESG service providers. This analysis is integrated into our overall score of a company. This deems whether a company is sustainable or not, provides a proprietary overall ESG score out of 10, and also gives the company a momentum score. This score takes a view on whether we think the company is going to improve in the future, based on current efforts. If the ESG team says that a company is not sustainable, the sustainable fund managers cannot invest in the company.

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Q7. How do you seize the opportunity and clean solutions angle in your strategy?

We seek to identify 'green' business solutions a company may present, to determine whether it will be suited to a net-zero carbon emissions world. A recent example of this was an analysis of a chemical company's crop-science division. We analyse a company's CDP score, Transition Pathway Initiative score, and whether it has science-based targets, which determine the quality of its climate-change strategy. We also look to see if the company is reporting in line with the TCFD recommendations, a best-practice disclosure framework for climate change readiness and action. If all this information is material, it is integrated into the company's overall ESG score and goes towards the responsible investment team determining if it is sustainable. We also look for commitment in a company's future strategy to R&D or new product lines which will deliver clean solutions.

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Q8. How do you specifically deal with fossil fuel companies? What do you expect to consider their diversification towards green activities is consistent and sufficient enough?

We are very sceptical of fossil-fuel companies that say they have sustainable business models as they have so much to change in the business models. To be convinced that an incumbent is sustainable, we require: a high percentage of the business to produce clean energy or solutions (above 50%); and/or a significant commitment to research and development; and/or concrete short and medium-term time-bound targets to decarbonise the business.

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Q9. What do you do in terms of engagement? Are you part of investor coalitions?

Another very important part of our ESG work is using engagement as a tool to push companies to improve. We engage with heavy emitters regularly, and ask all businesses to report in line with the TCFD recommendations. We also believe in the power of investor collaboration and are members of the Institutional Investors Group on Climate Change (IIGCC) and sit on the sub-advisory committee on AGM resolutions and within the corporate engagement programme. We are active Climate Action 100+ members and are leading and supporting engagements with a number of companies. We also use our voting power to submit shareholder resolutions on climate change, and recently did this very successfully at BP's 2019 AGM. Our engagement step is to engage with companies that are "improvers" and which we believe can improve their ESG/sustainability score. This is time bound, and if improvement is not made, then the fund manager can divest.

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