Responsible Capitalism in the US – the complete report

Rathbones
Look forward

Foreword

Greg Mullins
Head of Sales
Rathbone Unit Trust Management

It can't be understated how quickly the world can change. In the few short months since Rathbone Global Sustainability Fund Manager David Harrison travelled to the US to meet with current and potential investments, the world as we know it was flipped upside down. As the coronavirus spread around the globe, entire countries went into lockdown and economies ground to a halt. From that point forward, governments dedicated their resources to containing the outbreak and mitigating its economic fallout.

There is little doubt that we have entered a challenging period for financial markets and the economy. Whether the recovery is V-shaped, U-shaped or something else, it will be almost impossible for investors to predict how these events will play out. Yet during challenging times like these, the principles of investing remain the same: stick to high-quality companies that have strong business models, are cash generative and are doing the right thing in society and the environment.

During David's trip to the US, he found a country where responsible capitalism has truly taken off, where people are much more aware of the social and environmental costs of doing business. Much like other parts of the world, investing along environmental, social and governance (ESG) principles is clearly ascendant in the US. And, perhaps as a result of the pandemic, the true importance of the S and the G – social and governance factors – is emerging.

The objective behind the Global Sustainability Fund is to create long-term value for investors, society and the environment through a sustainability theme. Companies are selected not only for their strong ESG characteristics, but because they contribute to a more sustainable world. This may be renewable energy, it may be software that helps people to work from home rather than commute to an office every day, or it may be companies that create products that cut down on energy consumption and waste.

In this report, David explores the landscape for sustainable investing in the US, from the growth of responsible capitalism from coast to coast and the technology companies that are creating sustainable solutions, to the rising importance of renewable energy. He discusses in detail his high-conviction to asset allocation and how the future of investing along sustainability and ESG themes goes beyond focusing on emissions and pure environmental factors.

For anyone interested in sustainability and ESG issues, this report offers thought-provoking insight into a rapidly evolving area of investing. Companies and investors alike are beginning to embrace ESG principles in large numbers and embed them into their practices. While this means the movement is still emerging and standards continue to be developed, it also means that new investment opportunities are arising with each passing day.

Contents

Still pursuing green (part one)

David Harrison
Rathbone Global Sustainability Fund Manager

David is the lead fund manager of the Rathbone Global Sustainability Fund, supported by Liz Davis and Neil Smith.

He joined Rathbones in 2014 and has 20 years' experience in equity analysis and fund management, including positions at Hermes and Goldman Sachs.

David holds the Investment Management Certificate and a BSc (Hons) in Economics and Politics from the University of Southampton. He is a CFA charter-holder.

Fake meat is just a headline-grabbing focal point for real ethical changes in the US. In the first of three chapters, Rathbone Global Sustainability Fund manager **David Harrison** explains why responsible capitalism is ascendant in America.

Responsible capitalism is running hot over in the US, and it looks like it isn't simply a flash in the pan. In November I took a trip across the Atlantic to meet some current and potential investments on their home turf. I found a whole society that is much more aware of the environmental and social costs of consumption and doing business than I have ever seen in America. Even more than my last trip six months earlier.

I first started working in responsible investments in the mid-2000s. Back then, responsible investing – and environmental, social and governance (ESG) in particular – was a niche corner of the funds world. Mostly catering for charities and other institutional investors, this method of assessing companies was little known, especially outside Europe. To increasingly see American companies address environmental and societal issues is fantastic. But while it's great to see this growing wave of sustainable thinking among American businesspeople, I reckon you need to be careful of the hype – some questionable businesses are trying to 'greenwash' themselves to fit in with the sustainability mood.

As you would expect, the West Coast leads the way in sustainability, both among businesses and consumers. But during my visit I was surprised by just how much the East Coast and Midwestern centres have caught up. Reusable coffee cups are everywhere, more and more taxis are hybrids, and there were a few electric buses too. I saw quite a few cyclists as well. This is big news in Illinois which, along with neighbouring Michigan, is car country. There are other changes in consumer behaviour too.

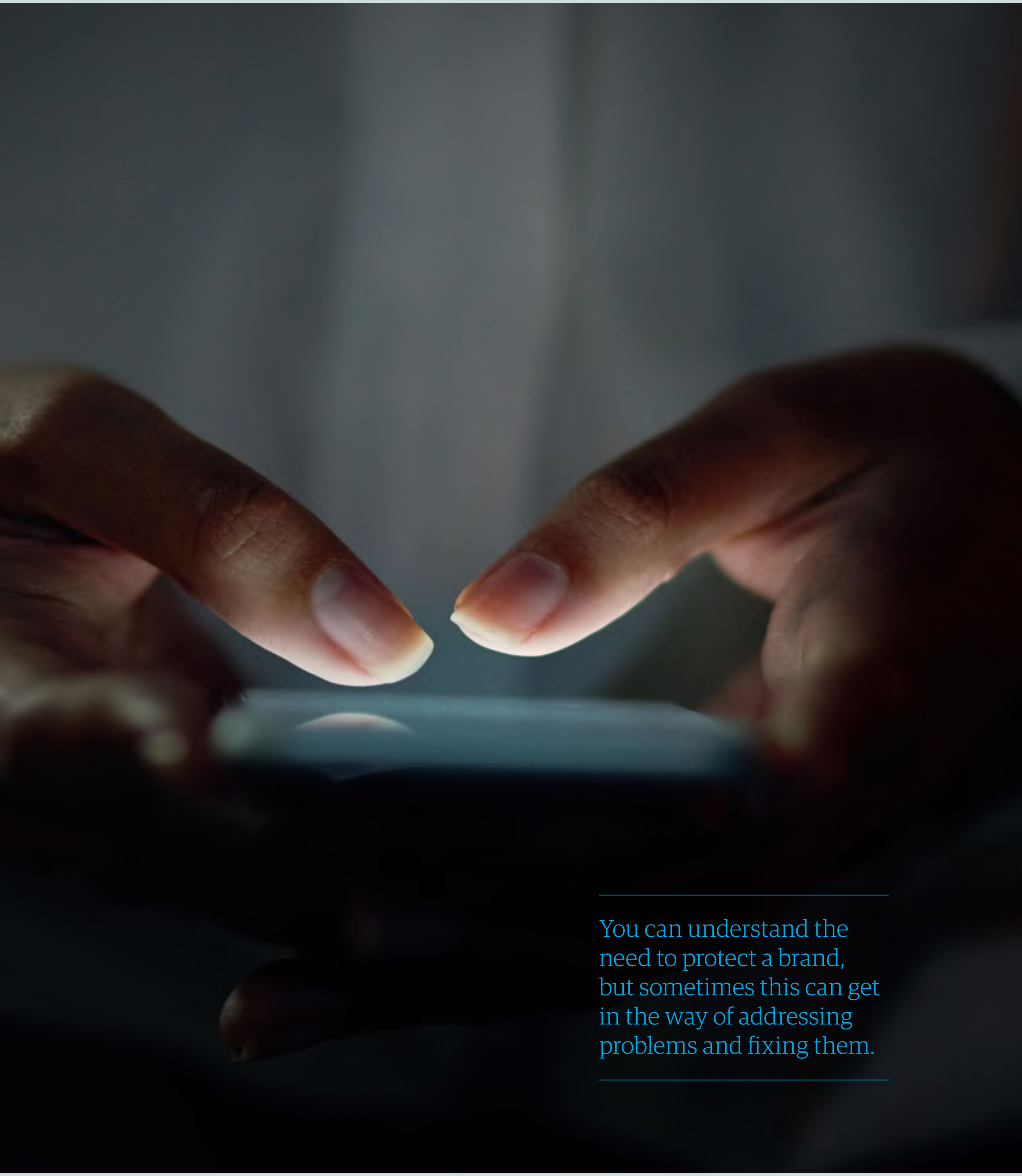
Faux meat companies like Beyond Meat have captured attention, but that's just the tip of the iceberg. There are meat alternatives, but they are only part of a general shift toward healthy eating and living that is particularly prevalent among the young. When I was a teenager, cigarette advertisements surrounded rugby pitches and the after-match feed was always burgers and chips. What a strange time. Now, younger athletes are more likely to have protein-powder milkshakes and remain teetotal.

After a slow, years-long wind-up of gluten-free options on menus and supermarket shelves, these options are now expected wherever you go. In the US, David Coombs, our celiac head of multi-asset investments, had an easier time with ordering food than I did. Vegan options have proliferated, albeit later, at a much more rapid pace. People used to be vegetarian for taste reasons or because they didn't want to be party to the death of animals. That has progressed now to a wave of people who understand the environmental effects of intensive animal farming – and the cruelty of some producers. Most menus in the States had calorie breakdowns too.

Blinded by the glare of transparency

Driven by the internet, our society has become radically more transparent – both online and in the real world. Most questions can be answered by simply asking the supercomputer in our pockets and the misdeeds of people and businesses can be called out and spread around the world in minutes.

This is a blessing and a curse. While it means that people can know more about the people, businesses and charities with which they interact, it also makes it easier for misinformation to spread, especially when coupled with new technology that can seamlessly alter photos, video and audio.



You can understand the need to protect a brand, but sometimes this can get in the way of addressing problems and fixing them.

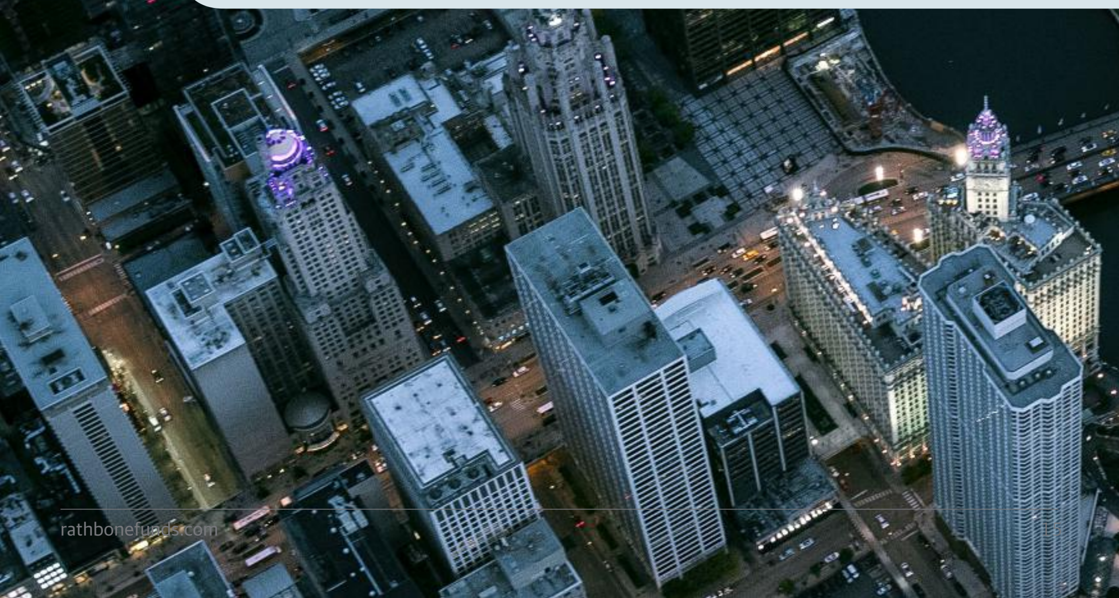
That's why we go to visit these companies. We want to make sure they aren't just fobbing off necessary issues, ensuring that they are truly on board with doing business the right way.

There's another problem with the bright, white glare of transparency. Because of the massive PR damage that can be done by an ill-judged unguarded comment or perhaps a legitimate policy that some may disagree with, it can lead business and political leaders to waffle and obfuscate. You all will have seen politicians on TV blatantly ignore an interviewer's questions and parrot the sanctioned party line. I have definitely sat through more than my fair share of C-suite interviews where companies have ignored questions they don't like or trotted out barely credible arguments about their operations.

You can understand the need to protect a brand, but sometimes this can get in the way of addressing problems and fixing them. It's a short-term stopgap instead of a long-term solution. And that can hold companies back from improving their impact on the planet and the people on it, as well as the bottom line. That's why we go to visit these companies. We want to make sure they aren't just fobbing off necessary issues, ensuring that they are truly on board with doing business the right way. We want to be able to talk to the managers of the businesses that we invest in, knowing that they are listening — that they want to hear what we and other investors like us have to say.

While in the US, I met many interesting businesses that offer solutions to some of our planet's most pressing problems. There was an online platform that harnesses all of our 21st century multimedia technologies to help kids learn, a bleach manufacturer that has implemented ESG processes to all of its operations and a Silicon Valley monster that is waging a war on the corporate world's mountains of paper and filing habits. There were so very many more too – 16 in total across four cities in five days.

I had quality conversations with some, so-so discussions with others and terrible encounters with a couple. What you would expect really when out searching for the very best businesses. I returned exhausted but with a bunch of companies that I'm keen to explore further. Some of them I may add to my portfolio in the coming months.

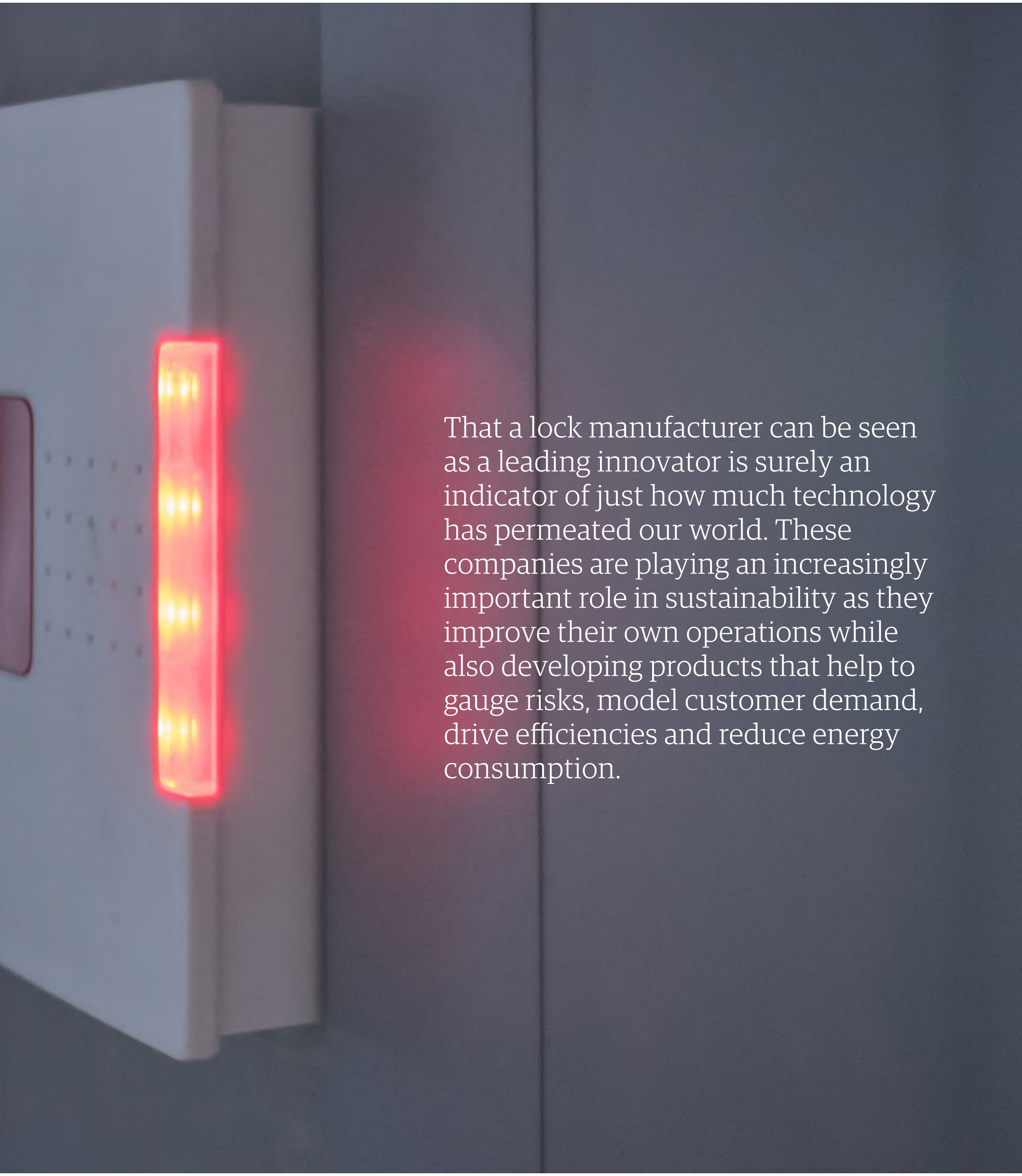


Technology's role in a sustainable future (part two)

A door lock manufacturer is probably not the first company that comes to mind when seeking sustainable investments. After all, how much can a company that makes locks and access control systems contribute to sustainability?

The answer is a lot. In increasingly connected homes and office buildings, doors can be opened wirelessly by a mobile phone. They can also be made to be more efficient, which reduces the amount of energy used to heat and cool buildings. Case in point: according to lock manufacturer Assa Abloy, the performance of doors and windows can influence up to 20% of a building's energy usage.[1]

1 Assa Abloy Sustainability Report 2018



That a lock manufacturer can be seen as a leading innovator is surely an indicator of just how much technology has permeated our world. These companies are playing an increasingly important role in sustainability as they improve their own operations while also developing products that help to gauge risks, model customer demand, drive efficiencies and reduce energy consumption.

When we think about technology as sustainability investments, we are casting a much wider net these days than we might have done in the past. As society pays closer attention to how our activities impact the environment, we are finding that sustainable technology now cuts across all sectors.

Rethinking sustainability

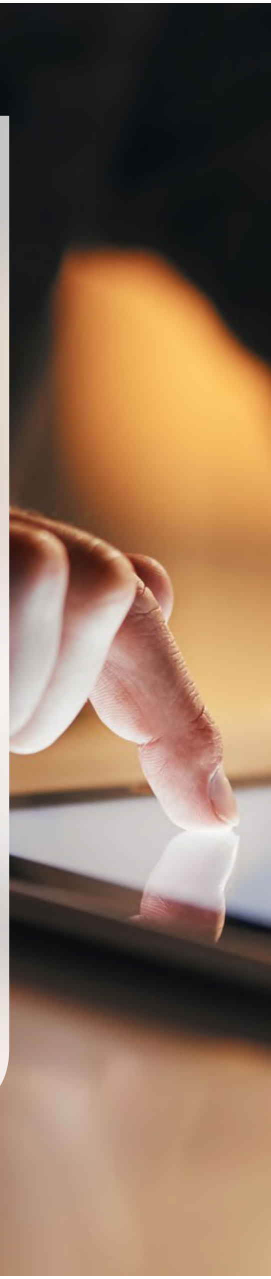
Another example of how sustainable technology can be put into practice comes from American software provider Ansys. The company develops simulation software that not only reduces consumption in the automotive and aerospace industries, but also helps consumer cosmetics manufacturers bring products to market more quickly by reducing the amount of time needed for physical testing.[2]

2 Ansys white paper

We not only view companies in terms of what they are producing, but also how they do it and how they treat their employees and engage with the world around them.

Industrial companies that operate in fairly mundane sectors are frequently investing more in the digital side of their market and solving a series of sustainable needs for their customers. For some companies in our portfolio, we have seen their earnings become steadier and less cyclical, and as a result they are benefiting from a re-rating by stock markets.

Of course, creating a product that purports to improve sustainability is not the only hurdle a company needs to clear to be included in the portfolio. We not only view companies in terms of what they are producing, but also how they do it and how they treat their employees and engage with the world around them. We are firm believers that businesses should do the right thing, and try to select companies that are making a positive impact in the world.



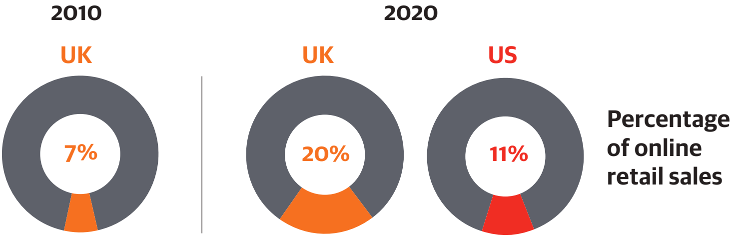
Reaching critical mass

It's because of the permeation of technology across society that I have such a high conviction in this area. While the tech companies of the late 1990s soared in value based only on hype and produced little in the way of tangible products, what we are seeing today is something completely different.

When we first launched the Rathbone Global Sustainability Fund, I had a healthy scepticism around the technology industry. It's easy to be wary given that many technology firms have higher valuations and are expensive to buy in the short term. However, my strong belief is that we have entered a multi-year structural change in the global economy, with the technology theme leading the way.

20% of all retail sales are online and that number rises with each passing year.

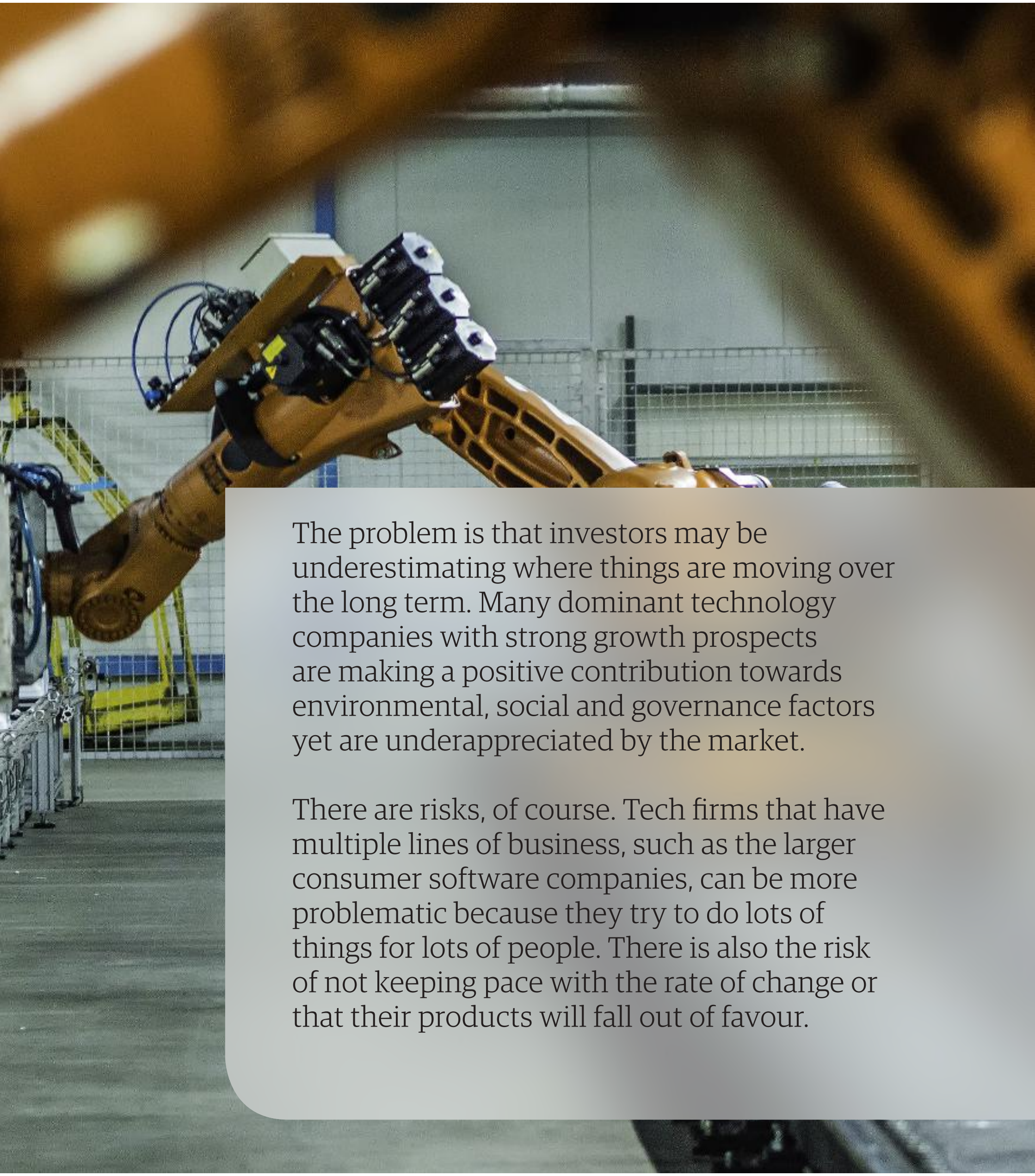
This is why around over 20% of the Rathbone Global Sustainability Fund's portfolio is currently tilted towards companies that offer a technology and innovation theme. Companies are under increased pressure to innovate and adapt, and there will be a clear divergence among those that are innovating, surviving and thriving, and those that are not.



One area where we are seeing this taking place is in online retailing. A decade ago, just 7% of retail sales in the UK were online. Fast forward to the present day and 20% of all retail sales are online and that number rises with each passing year.[3] The ratio is smaller in the US, around 11%, but the growth is rapid — to the tune of about 15% year-on-year.[4]

3 Retail Sales — Office for National Statistics

4 Retail growth — US Department of Commerce



The problem is that investors may be underestimating where things are moving over the long term. Many dominant technology companies with strong growth prospects are making a positive contribution towards environmental, social and governance factors yet are underappreciated by the market.

There are risks, of course. Tech firms that have multiple lines of business, such as the larger consumer software companies, can be more problematic because they try to do lots of things for lots of people. There is also the risk of not keeping pace with the rate of change or that their products will fall out of favour.

Hidden in plain sight

It would be hard to overestimate the contribution that technology is making towards the global economy generally and sustainability specifically. The pace of change is accelerating and we are seeing technology touching more of our daily lives than many of us ever thought it could. People talk about it frequently, but I firmly believe its impact is not fully understood.

When you look at the world around us, it becomes clear: work habits are changing, companies making consumer goods are seeking to become more efficient, and the industrial sector is making inroads into cutting emissions and energy consumption.

Technological advances are cascading into every market and sector and this is creating attractive opportunities for us as investors. These companies will have sensible management teams, a clear focus on sustainability in their operations and the products they provide, and a business model that offers solid revenue and durability of returns over the long term.

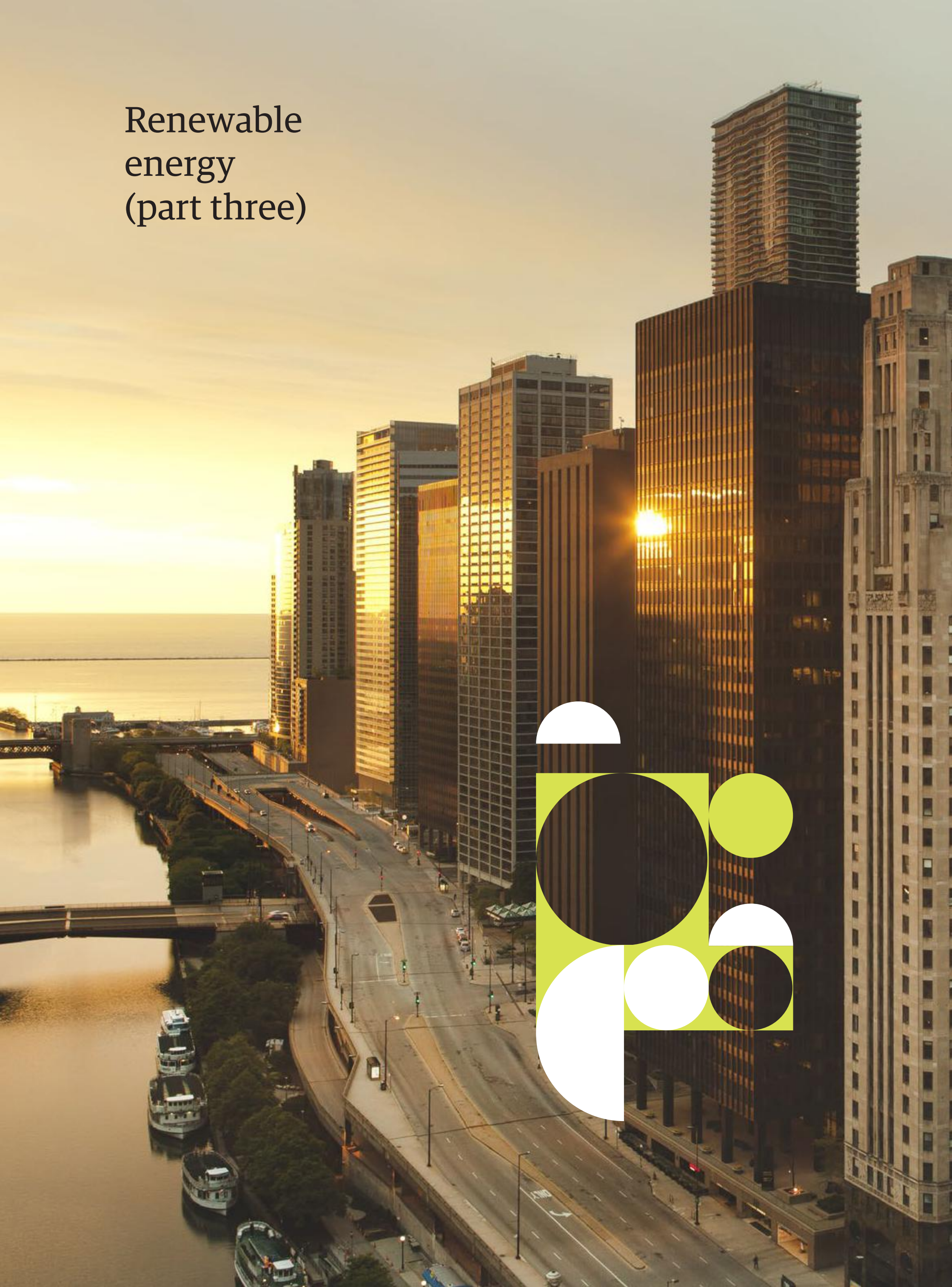
1 https://www.assaabloy.com/Global/Sustainability/Sustainability-Report/2018/Sustainability%20Report%202018.pdf

2 https://www.ansys.com/resource-library/white-paper/designing-the-optimal-product-using-simulation-tools-to-innovate-and-reduce-time-to-market?p=Consumer%20Goods%3A%20Product%20Development%20Simulation%20%7C%20ANSYS%2CConsumer%20Goods%3A%20Product%20Development%20Simulation%20%7C%20ANSYS

3 https://www.ons.gov.uk/businessindustryandtrade/retailindustry/timeseries/j4mc/drsi

4 https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf

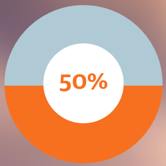
Renewable energy (part three)



Renewable energy has always played a minor role in the US energy market. While the movie industry has long portrayed California as being awash with wind turbines, its silver screen fame far exceeds its output. Even today, wind energy accounts for just shy of 10% of the US's electricity production; not totally insignificant, but a minor player nonetheless.

Even so, there are signs that renewables are beginning to gain greater traction in the US — and elsewhere in the world — as the overall drive for sustainability takes hold. Indeed, renewables are forecast to account for around 25% of the US energy generation mix by 2050.[1] On top of this, since 2019 we have seen 10 US states, more than 100 cities, and a number of major US corporations committing to renewable energy targets. At a global level renewables have a stronger foothold, at around 26% of total electricity generation, and there are predictions that this will rise to nearly 50% by 2050.[2]

Predicted global renewable energy generation in 2050[2]



Forecast USA renewable energy generation in 2050[1]

1 EY accelerated energy transition

2 Bloomberg new energy outlook 2019

The noticeable rise of renewable energy echoes the transformation I've observed in other US industries, where a combination of increased awareness and customer demand are effecting significant change. In the previous two chapters in this series, I discussed how US consumers and companies alike have become more aware of how their consumption affects the world around them, and how technology has an important role in enabling a more sustainable future.

Whether it is the trend towards plant-based diets, the rising popularity of greener forms of transportation, or the noticeable effort among corporations to address environmental and societal issues, I got the feeling that a societal shift is underway. In a country where fossil fuels are king and currently produce around 80% of its energy, this is a major development. It's clear that there is a desire in society and government for change, and steps are being taken to achieve it.

There is little doubt that non-hydro renewable energy, led by solar and wind power, are on a solid growth trajectory. Nevertheless, this is a slow-moving trend that will be played out over several decades rather than in a few years.

The great energy rotation

One reason for this is that the shale gas revolution of the past decade had a major influence over the US energy market; the switch to natural gas power plants from their dirtier coal-fired cousins is helping to drive down carbon dioxide emissions from electricity by 26% between 2008 and 2018.[3] With cleaner shale gas being abundant and at an attractive price, it was the logical choice for many power generation companies.

3 US Energy Information Administration Monthly Energy Review May 2020

Helping to drive forward the case for renewables is the fact that, in many regions, wind power is now the cheapest form of energy generation. Analysis by the US Department of Energy at the end of 2019 found that wind farms are cheaper to build and operate than gas-fired power plants.

The cost of wind power in the US had in fact increased steadily up until 2009, when power purchase agreements for wind-generated electricity peaked at about $70 per megawatt-hour. Prices have declined steadily since then, with the national average falling below $20 per megawatt-hour for the first time.

In Europe, renewable energy gained a larger foothold much sooner than in the US. The share of renewable energy in gross final energy use in the EU has doubled since 2005, according to data from the European Environment Agency. By 2018, renewables accounted for 18% of all energy use in the European Union (EU), with renewables accounting for 30.7% of electricity consumption.

In many regions, wind power is now the cheapest form of energy generation.

Seeking exposure

Given the renewable energy market's potential for growth, there is little doubt that it can be an attractive investment opportunity.

The objective of the Rathbone Global Sustainability Fund is to create long-term value for investors, society and the environment through companies that display strong environmental, social and governance (ESG) principles and follow a sustainability theme. The companies that I select for the portfolio are therefore high-quality, cash generative businesses with strong franchises, have no financial stress and are long-term thinkers.

As a fairly niche market, the options in renewable energy are admittedly limited compared with other industries. For starters, many wind turbine manufacturers are subsidiaries of larger industrial conglomerates, such as General Electric or Siemens, which means they may not be pure-play renewable energy investments. Others, meanwhile, may not be attractive from a profitability and cash-generation standpoint. For this reason, less than 10% of the Rathbone Global Sustainability Fund's portfolio is invested in renewables.

Nevertheless, when we look only at the companies that are fully focused on renewable energy, a few shine through as ticking all of the right boxes. In the US, we found an opportunity with companies that finance and develop energy-efficient buildings and renewable energy-generation projects. One example is Hannon Armstrong, which provides loans to customers to help them finance projects in the following areas: retrofitting buildings to make them more energy efficient and installation of solar panels in the residential housing market. The company also invests in wind power and leases land to be used for large solar farms.

Outside of the US, companies such as Vestas and EDP Renováveis are examples of high-quality operators in the renewables sector that complement each other, rather than overlap. Vestas is the largest wind turbine manufacturer in the world, with an order backlog in the region of €32.8 billion.[4] It faces stiff competition from the likes of Siemens Gamesa Renewable Energy, Goldwind and General Electric, but it is in a strong position because it is seen as a leader in the renewable energy sector and has a strong business model. It is protected by high barriers to entry and is well placed to capitalise on the growth of the wind energy market as the world moves away from fossil fuels.

The companies that I select for the portfolio are therefore high-quality, cash generative businesses with strong franchises, have no financial stress and are long-term thinkers.

4 Barron's Vesta article

EDP Renováve (EDPR), on the other hand, finances, builds and operates renewable energy projects including solar as well as onshore and offshore wind farms from start to finish. It will either retain ownership of the project or it may sell the asset to another investor, such as a pension fund, and then continue to operate the site under a management agreement. As a group, EDPR, Hannon Armstrong and Vestas represent most of the supply chain in renewable energy, from financing a project to the provision of infrastructure and then the ongoing management and maintenance.

Towards a sustainable future

Sustainable investing is as much about environmental factors as it is about social and governance concerns.

When we think of responsible capitalism, the first thing that comes to mind is doing the right thing. Regardless of sector or industry, the most successful companies in our evolving society will likely be those that have sensible management teams, a clear focus on sustainability in their operations and the products they provide, and a business model that offers solid revenue and durability of returns over the long term.

Simply investing in a wind turbine manufacturer because it contributes to a sustainable form of electricity is not good enough. The company needs to be a solid performer not only from a financial perspective, but also from a sustainability perspective.

Sustainable investing is as much about environmental factors as it is about social and governance concerns. In the US as well as the rest of the world, it's clear that we are beginning to see a societal shift towards greater awareness of how our actions impact on the environment and our communities. The companies that are most successful at establishing a strong market position and building a positive and sustainable business model stand a good chance at delivering over the long term.

Get in touch

For more information, contact the team on 020 7399 0399, rutm@rathbones.com or visit rathbonefunds.com

1 https://www.ey.com/en_us/power-utilities/in-an-accelerated-energy-transition-can-us-utilities-fast-track-transformation
2 https://about.bnef.com/new-energy-outlook/
3 https://www.eia.gov/totalenergy/data/monthly/
4 https://www.barrons.com/articles/worlds-largest-wind-turbine-maker-vestas-climbs-on-record-orders-51573132569

T3-IFA-USA3-06-20

Rathbones
Look forward

rathbonefunds.com
rathbones.com
@Rathbones1742
Rathbones professional advisers
Rathbone Brothers Plc