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Fundamentally speaking: Sustainable investing

January 2020

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"There is one and only one social responsibility of business – to use its resources and engage in activities designed to improve its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception and fraud" **Milton Friedman, Capitalism and Freedom, 1962.**

The cynical view of sustainable investing has always been that the consideration of sustainability leads to inferior investment performance.

The two most important questions here are, firstly, how do you define sustainability and, secondly, what proof if any is there that such trade-offs exist?

We argue that Friedman's perspective on profit maximisation remains intact and the inclusion of sustainability considerations enhances a business' ability to actually maximise profits and ultimately long term value for shareholders. Time horizon is critical in this judgement; the longer our holding period, the more likely this relationship is to hold.

Defining sustainability

At the heart of any definition of sustainability has to be the consideration of environmental, social and governance (ESG) issues. We agree that these are important components in determining the sustainability of any business but, not the only ones.

A full consideration of a business' sustainability must also consider the sustainability of its economic model. There is nothing sustainable about a company that cannot make, or cannot sustain, returns above its cost of capital; eventually such a business is unlikely to be a going concern.

We also believe that sustainability is a mindset and not something achieved by accident. It becomes clear when interacting with a company whether or not it has put considerations of ESG and economic sustainability at the heart of its strategic planning. Companies that fail to do this are unlikely to deliver acceptable returns to their shareholders in the long run.

Finally we have to acknowledge that the judgement on what constitutes a sustainable investment has many stakeholders, and it is important that the views of our underlying clients are taken into consideration. To that extent, sustainable investing requires an acceptance that the investor will exclude industries or companies which are generally accepted to not be sustainable. Our experience is that the judgements of investors and clients rarely come into conflict on this issue.

In summary, we define sustainable investing as:

1. The consideration of ESG issues as the first step, but not the only one.
2. An analysis of sustainability in the broadest sense, including the financial outcomes of the business.
3. A judgement on whether companies are taking sustainability seriously in terms of corporate strategy and senior management attention.
4. The exclusion of certain industries and businesses which either we or our clients view as unsustainable.

Why there is no trade-off (1): companies

It has always been our view that pursuing sustainability does not require a company to accept higher costs or lower revenues.

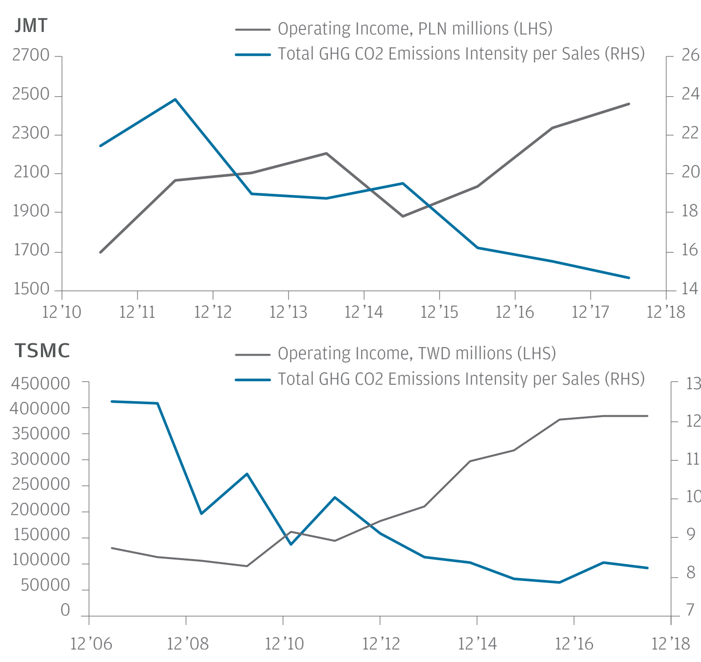
A company that focuses on serving its customers well, on making the workplace a great place to be and on contributing to the communities in which it operates should have a higher likelihood of being a better long term investment.

Firstly we can look at two very different businesses. Jeronimo Martins, a food retailer with operations in Portugal, Poland and Latin America, and TSMC, the world's largest manufacturer of semiconductors. What links the two companies is that both have been able to consistently reduce the carbon intensity of their businesses while continuing to grow profits (**Exhibit 1**). Lowering the energy intensity of an organisation can have positive implications for cost.

Securities are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

J.P.Morgan
Asset Management

EXHIBIT 1: JERONIMO MARTINS AND TSMC OPERATING INCOME AND CO2 EMISSIONS PER SALES



Source: J.P. Morgan Asset Management, company filings; data as December 2019. The carbon intensity is the total tonnes of CO2 emissions for every million in sales.

A similar example would be Anheuser-Busch Inbev, the world's largest brewer. Management of the company has stated that the vast majority of their environmental and social initiatives generate a positive net present value (NPV).

These are not unique cases. Our interactions with corporates contain a repeated theme: companies with well thought out initiatives on sustainability see a positive economic case for these projects.

The benefits to the corporation do not stop at lowering costs. There is also a revenue opportunity for companies with a strategic approach to sustainability.

Our research team recently conducted a detailed project on the Asian textile sector and the material ESG considerations that businesses in this sector face. The project highlighted a Hong Kong listed company, Shenzhou International, as a clear leader on sustainability.

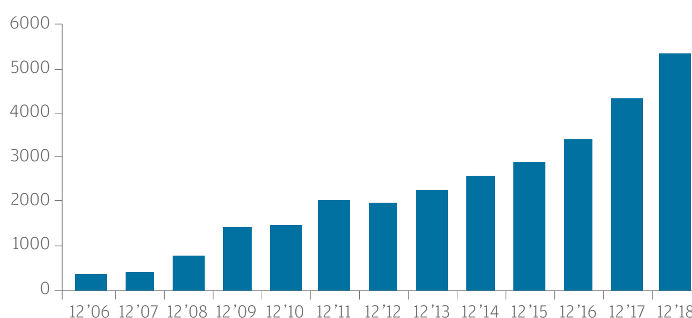
The treatment of workers is one of the most material sustainability issues in the sector. Shenzhou stood out for having more flexible arrangements in working hours, more frequent breaks, better residential and entertainment facilities and fairer compensation. It was also a leader on environmental issues like water usage.

In addition to this ESG strength, Shenzhou is also a leader in how it thinks about economic sustainability. It has a strong research and development (R&D) culture, and it was its research into new technologies which produced a new manufacturing technique that proved to be one of the key enablers of Nike's Flynit footwear range. The pioneering production method – weaving the shoe from one continuous thread instead of stitching together separate pieces of fabric – created a hit product which had better athletic performance but also with 80% less material wastage.

Shenzhou's focus on ESG considerations enabled it to win marquee customers like Nike and Adidas since these businesses also increasingly care about the sustainability of their own supply chains. Its focus on economic sustainability then saw it innovate a product which grew those customer relationships while also reducing its environmental footprint. This is a clear example of how both aspects of sustainability – ESG and economic – are important and interrelated.

The chart below shows the profit trend of Shenzhou International over the last decade. The company's focus on sustainability has only had positive implications for earnings.

EXHIBIT 2: SHENZHOU INTERNATIONAL, NET PROFIT, HKD MILLIONS



Source: J.P. Morgan Asset Management, company filings; data as December 2019.

More generally as customers of all businesses increasingly care about these issues, enterprises that do not innovate their products and services to take account of sustainable considerations will fall behind. This truth is timeless. As far back as 1973 Peter Drucker wrote: "There is only one valid definition of business purpose: to create a customer. . . . It is the customer who determines what a business is. It is the customer alone whose willingness to pay for a good or for a service converts economic resources into wealth, things into goods. . . . The customer is the foundation of a business and keeps it in existence." As customer preferences shift, businesses also need to change if they are to prosper.

The contrast to these two examples is the losses suffered by shareholders in businesses who have failed to adequately manage sustainability issues.

In 2011 a restaurant operator in China, Ajisen, experienced a food safety scandal due to a lack of supply chain controls. The business suffered in the short and long term as the initial issue was compounded by the company's failure to come up with an adequate strategic response.

This is an example of how failing to embed sustainability at the heart of corporate strategy has negative consequences for long term returns. The stock is down 90% over the last 8 years (see **Exhibit 3**) and the business is still generating sales below those of 2011.

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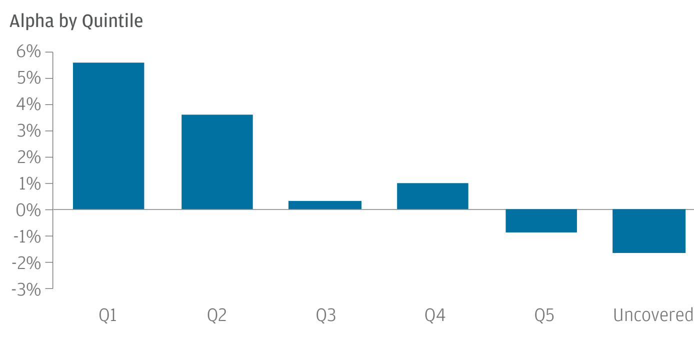
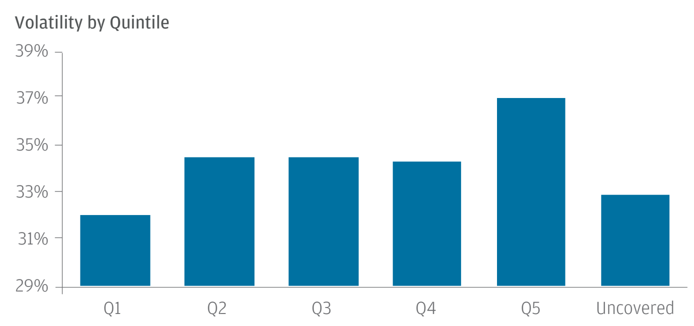
EXHIBIT 3: AJISEN SHARE PRICE

Source: J.P. Morgan Asset Management; data as December 2019.

EXHIBIT 4: PERFORMANCE AND RISK BY SUSTAINABILITY QUINTILE



Source: J.P. Morgan Asset Management; data as of 31 October 2019. Time period February 2013 – October 2019. Q=quintile.



Source: J.P. Morgan Asset Management; data as of 31 October 2019. Time period October 2013 – October 2019. Q=quintile.

Perhaps the most famous example of an ESG transgression was BP's Deepwater Horizon spill. In that year the company made a loss and nearly a decade later the stock price has failed to climb above the level prior to the incident.

In emerging markets we recently saw a similar issue when a tailings dam owned by Vale, a Brazilian miner, collapsed killing more than 100 people. This incident has brought heightened scrutiny by regulators and government and will likely see a material increase in costs for the business.

There is an economic cost for those who ignore sustainability.

Why there is no trade-off (2): investors

There are now numerous studies demonstrating that the inclusion of sustainable factors either helps improve shareholders returns or at least does not detract from them. This result should not be a surprise given the evidence at the corporate level that we have already shown.

Our own internal analysis of emerging market investing shows a similar conclusion. Our analysts cover over 1,000 stocks in emerging markets and for each one they complete a 98 question risk profile, two thirds of which relates to ESG factors and one third of which relates to broader questions of economic sustainability.

Since we started compiling this data the top quintile of sustainable businesses have materially outperformed the bottom quintile, and with less risk (**Exhibit 4**).

Narrowing one's investment universe does not require trade-offs if the businesses that are left are, in the broadest sense, more sustainable enterprises.

The idea that a more selective universe does not diminish returns is one that Warren Buffett has always made with regard to economic sustainability, stating that he first decides whether he can estimate businesses' economic characteristics five to ten years out and, if he can't, "then he eliminates them from consideration right there". We take a similar view while broadening our filter to include ESG as well as economic considerations.

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Why there is no trade-off (3): time horizon

The longer your time horizon as an investor the more sustainability issues make a difference. We typically look to hold investments for at least five years which is why we have always considered sustainability as a core topic within our investment analysis.

As investors we also have to reflect this long term view in our interactions with companies. We cannot focus on the next set of quarterly results or ask corporates for annual guidance. If we want businesses to take long term strategic decisions then we, as investors and shareholders, have to interact with companies in a way which supports this. Certain corporates have already taken this step with Unilever, under the previous CEO Polman, having moved away from earnings guidance and quarterly profit reporting.

Conclusion

There is no conflict between the Friedman view, that profit maximisation should be the single focus for corporates, and a focus on sustainability.

The consideration of sustainability will, over the long term, provide companies with stronger and more durable moats to their business. This will in turn drive value for those shareholders whose time horizons are aligned with the strategies of the companies in which they invest.

We believe that as investors we will seek to make the most attractive risk adjusted returns in the most sustainable businesses.

AUTHOR: AMIT MEHTA

JPMorgan Funds - Emerging Markets Sustainable Equity Fund

Investors can access the sustainable investment approach of J.P. Morgan Asset Management's emerging market equity team via the JPMorgan Funds - Emerging Markets Sustainable Equity Fund.

In this fund, we exclude unsustainable industries and businesses and invest in the companies our analysts have identified as sustainable leaders or those that are demonstrating improving sustainable characteristics.

As long-term investors, we are supportive of companies implementing positive change and improvement.

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