ESG:

Much more than a must

By: Antonio Miranda, Partner and chief investment officer of Compass Group.

Compass Group's responsible investment framework has always been based on "do no harm" and "good environmental, social and governance (ESG) practices are good for financial returns[1]". As social and environmental challenges become urgent, our clients, our employees and our corporate citizenship are driving us towards greater engagement. We all need to do more.

As many of our invested companies and clients know, Compass Group has long considered ESG issues when analyzing potential investments. In 2016, we began to incorporate ESG metrics systematically in credit ratings.. From that experience, it became intuitive that our ESG assessment should also impact cost of equity[2], which was later confirmed by research and, since then, has been integrated into our valuation guidelines. Our approach to full ESG integration is such that we don't have ESG specialists as part of the investment team – we are all ESG specialists.

Our proprietary ESG questionnaire is an integral part of our bottom-up analytical toolkit. Resulting company ESG score impacts credit ratings, valuations, portfolio risk management and serves as a guide for our ongoing engagement with our invested companies. ESG engagement is a natural progression of investment philosophy. Our research is high-touch oriented and has boots-on-the-ground. We meet with Latin American issuers over [1800+] times per year with the objective of learning and sharing our views about operations, strategy and ESG. For the companies in which we own significant stakes, an issuer ESG review committee defines specific areas of engagement to extract maximum value for our clients' portfolios.

As a firm, we have had greater focus on governance, since our research shows that good governance tends to drive good environmental and social practices, although there are exceptions.

Now we are improving our practices around climate impact and social issues. A task force is currently updating our bottom-up analytical framework to systematically include a materiality matrix that will highlight issues to be included for valuations and scenario analyzes. Today we estimate the carbon intensity and footprint of all our portfolios and identify high polluters. We also vet labor and community relations and scan for controversies. We are refining our engagement protocols to deal with large carbon footprint and high intensity emitters.

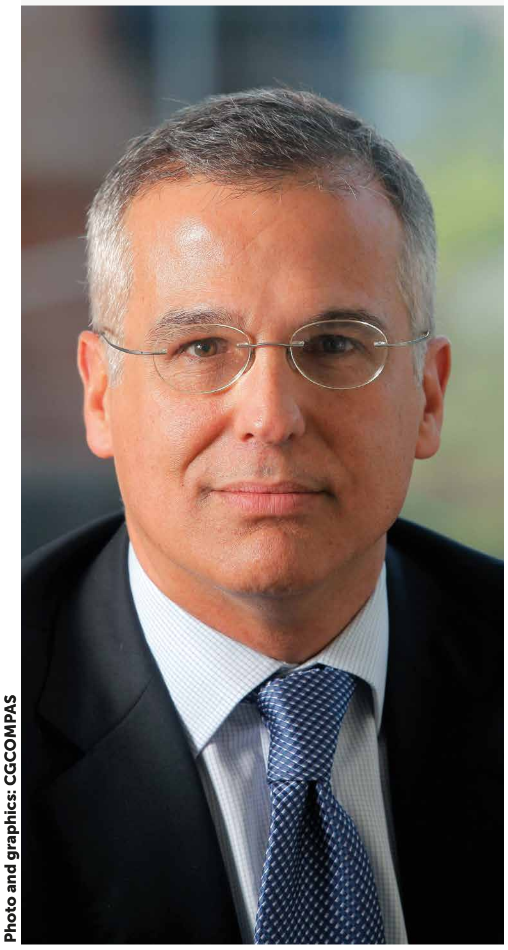


Photo and graphics: CGCOMPAS

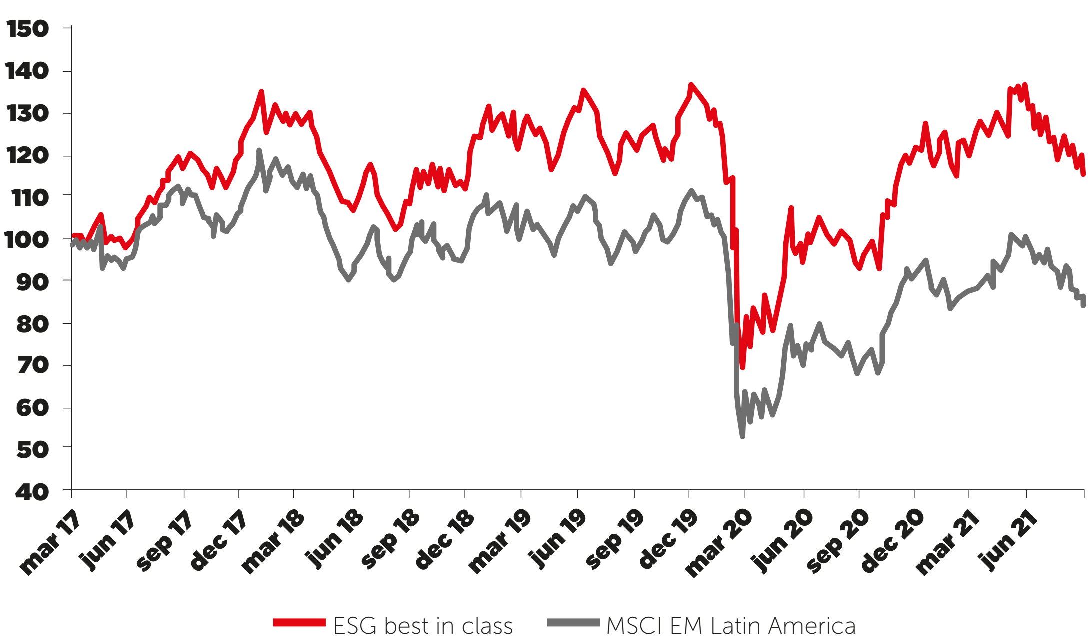
As a fiduciary of our clients' capital, our process has evolved with the clear goal of delivering best in class investment performance while our ESG integration seeks to improve returns. We anticipate clients asking us to engage in 'impact' strategies, where returns will be combined with non-financial objectives.

As good corporate citizens we support asset managers and owner's efforts to improve responsible investment practices, including contributing to the United Nations Sustainable Development Goals. Our industry can serve as a catalyst to the implementation of smart technologies and practices that align improving returns with positive impact on environment and social issues. That alone, however, is unlikely to take us to Net Zero by 2050. Policy development is required to solve for an adequate long term capital allocation. Capital starved old economies and carbon intensive industries can generate economic imbalances, especially in emerging economies.

A case in point is the cement industry. Much can be done to reduce emissions by deploying technology, but every scenario for Net Zero requires deploying carbon capture techniques or buying carbon credits at a significant cost to consumers.

In the meantime, transparency is critical. We cover over 600 companies in Latin America. We estimate that around 50% of them do not disclose the impact of their emissions. Even though Latin America is behind in term of ESG issues, we have observed how management teams are convinced of the benefit of improving standards. We believe good ESG practices are not only an obligation towards society, but also a valuable source of information that yields sustainable returns.

ESG BEST IN CLASS OUTPERFORMANCE

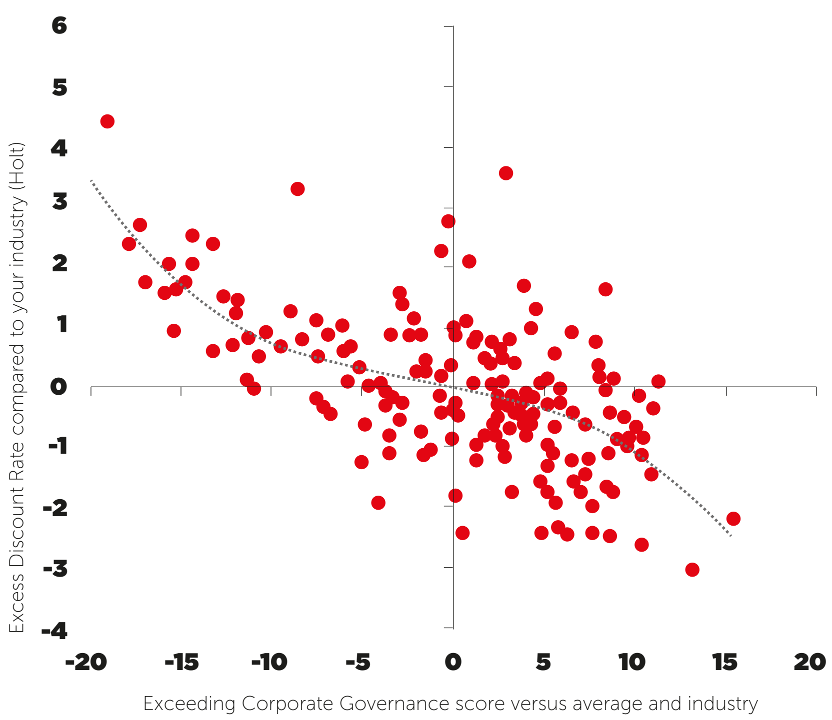


In the graph above, it can be seen how a theoretical portfolio "ESG best in class" has better returns over time than the MSCI EM Latin America index. This portfolio is made up of the companies in the highest quartile of score in our ESG questionnaire.

SOURCE: COMPASS GROUP, BLOOMBERG. INFORMATION AS OF SEPTEMBER 28, 2021.

EXCESS OF DISCOUNT RATE VERSUS CORPORATE GOVERNANCE QUALITY

Companies under Compass coverage in LatAm



SOURCE: COMPASS GROUP.

[1] Include back test top quartile G scores portfolio vs MSCI LatAm graph.
[2] Include cost of capital adjustment vs G scores graph.