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Q&A BAILLIE GIFFORD

ESG investing can drive resilience, longevity and growth

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Why should a charity think about sustainable income?
Ideally, a charity's investments will meet three financial goals: resilience, longevity and growth. Resilience means that even in difficult economic times, the investment should still be able to fund the charity's expenses. Longevity means the investments should last for many years to support the charity's ongoing mission. Growth means that even if inflation is increasing the charity's costs, its investment returns should at least cover those rising costs and better still exceed them, allowing the charity to fund more expenditure.

> ESG challenges are long-term in nature

The traditional way of investing for charities was to seek investments with a high yield, which seemingly delivered more income per unit of capital invested. The problem is that strategy usually fails the goals of resilience, longevity and growth. A high dividend yield is often symptomatic of a company that is either overpaying an unsustainable dividend or running out of growth opportunities. There is a high risk that such income will eventually get cut, failing the longevity test. We saw this during the pandemic, when many high-yield investments reduced or cancelled their distributions, which, together with interruptions to fundraising activities, forced some charities to pull their support at a time when it was most critical.

A much better strategy, we believe, is to focus on sustainable income. This means focusing on investments which, by definition, should be resilient, long-lasting, and growing. Typically, these investments will have slightly lower dividend yields. But they are likely to be far more resilient. They are likely to last far longer. And they have a much better chance of growing ahead of inflation. A sustainable income approach is therefore much better suited to a charity's long-term financial goals.

What does a long-term investment horizon mean for environmental, social and governance (ESG) analysis?
ESG analysis has now reached many corners of the asset management industry, at times turning into outright greenwashing. For charities, ESG issues can be particularly important, and expectations are high. Charities are often at the leading edge of raising social, sustainability or governance issues with the companies they invest in.

One thing to remember, however, is that some of the most critical ESG challenges are long-term in nature. Think of climate change or biodiversity loss, for example. These are slow-moving changes whose effects will take decades to materialise.

For investors, we believe this means spending time delving into these issues to understand the long-term impact they have on companies they invest in, rather than outsourcing the analysis to ratings agencies like MSCI or Sustainalytics. It also means building relationships with companies over the years to accompany them on that journey.

A long investment horizon allows time for that in-depth assessment and relationship building, ensuring the focus is on addressing material issues that will continue to be relevant, rather than tackling the ESG issue of the day.

So, in our view, charities should require their investment managers to undertake serious analysis, do that analysis in-house rather than outsourcing it, and think long term when assessing ESG topics.

Are there any other benefits of this strategy?
There are additional benefits for patient investors with a long investment time horizon.

To begin with, most financial market participants are fixated on the short term. Companies give guidance on next quarter's results, analysts and brokers discuss short-term prospects and many investment managers are incentivised on short-term performance.

We believe this fixation leads market participants to confuse noise and signal, creating mispricing opportunities for more patient investors. For example, long-term dividend compounders are rare, but often mispriced by the market.

A long investment horizon also gives managers the freedom to spend time on deep and meaningful research. Understanding a business and its long-term prospects takes time, which you are unlikely to spend if you are a shareholder for only a few months.

So, if the odds of delivering better performance are higher for long-term investors, why aren't we seeing more managers adopt a similar stance? Mostly because many investment managers do not have the incentive nor the structure in place that would allow them to. Investing for the long term involves the risk of deviating from performance benchmarks over short periods of time. In most cases, this is a risk they are not willing to take.

Can investors really influence change?
Yes, investors can really influence change. And they should, since they are stewards of their clients' capital.

Voting is the simplest way for investors to influence companies' decisions directly. Hence the rapid increase over the past few years in the number of shareholder proposals put forward at company AGMs, often related to ESG issues.

But voting is not the only way. Engaging with companies and probing them on relevant ESG issues is another constructive way for investors to influence change.

The challenge, however, is that the decisions companies make on some issues today may not pay off in the future. So, for an investor holding shares for just a few months, there is no incentive to push for action which will necessitate costly changes in the short term for an uncertain result in the long term.

Again, the chances of having a real and positive impact on a company increase with being a long-term supportive shareholder. It helps relationships to form and aligns with the objectives of management teams which also take a more patient approach.

In summary, investors can, and should, influence change. And we believe charities can, and should, challenge asset managers to use their scale, expertise and access to push for that change.

FAST FACTS*

Over a century of investment expertise.

Managing approximately £5bn on behalf of our charity clients.

Over 50 years of building long-lasting relationships with charities.

*All figures as at 20 March 2023

BAILLIE GIFFORD

WHAT WE DO

Our sole purpose as a firm is to help our clients meet their investment objectives over the long term. Baillie Gifford has over a century of investment experience and has been helping charity, foundation and endowment clients meet their investment objectives for over 50 years. As a private partnership, we have the stability to be able to take a long-term approach, which prioritises the search for sustainable growth and superior returns. We seek the best opportunities from around the world and combine them into high-conviction portfolios, delivering results which are very different to those of any other index or manager. We manage investments for a broad range of charity clients spanning areas such as healthcare, education, faith and the arts. Our clients' investment focuses range from equities to multi-asset mandates, from income to total return objectives, and from ethical considerations to societal impact.