ENGAGEMENT: The Silent E in ESG Analysis

WHY SMALL CAP MANAGERS MUST DIG DEEP TO UNDERSTAND ESG RISK

The integration of Environmental, Social, and Governance (ESG) factors into investment decisions has rapidly become standard practice for most institutional asset managers. Notably, in just a few years, our conversations with consultants and asset allocators have moved from being asked *if* we incorporate ESG into our process, to *how*.

It's always an enriching discussion because the process of ESG measurement plays to our strengths and we present a unique perspective as a research-intensive small-mid cap investor. ESG is deeply-embedded into our process as active, bottom-up managers and we've developed a considered viewpoint about what works — and what doesn't — for the small-mid-cap asset class, which we share in this thought piece.

Key Takeaways

- ESG performance measurement is a nascent and evolving field — complex, partly subjective and not easily quantifiable despite the profusion of third-party rating agencies.
- Assessing ESG within the small-cap asset class has unique challenges due to their early stage in the maturation cycle, lower levels of ESG disclosure and narrow coverage by ratings agencies.
- For investors to derive meaningful ESG insights, two components must be in place: a well-constructed internal framework and engagement with company management.
- A well-executed ESG process can help reduce portfolio risk and lead to sustainable risk-adjusted returns.

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INVESTMENT COUNSEL

ESG: AN INTEGRAL YET IMPERFECT SCIENCE

As responsible investors and signatories to the UN Principles for Responsible Investment, we view ESG analysis as a fundamental component of risk management that helps to generate superior risk-adjusted returns.

We invest in strong, entrepreneurial businesses with sustainable competitive advantages.

Companies with poor ESG ratings are associated with higher costs of capital and increased levels of volatility, as measured by size and frequency of drawdowns due to negative events and other risks.[1]

After all, if companies don't consider the interests of their employees, suppliers, communities and other stakeholders, there is exigent risk that corporate value will be destroyed. As such, understanding and engaging with the companies in which we invest is a critical element of our investment process — not to improve short-term investment gain — but to minimize the potential disasters that may befall those unwary of the risks beneath the corporate visage. As long-term investors, we know that managing downside risk is key to long-term outperformance.

Despite its rapid and widespread adoption, the field of ESG performance analysis is nascent.

An absence of accepted measurement standards and the varying, opaque methodologies used by third-party ESG ratings agencies are a few of the growing pains that make it difficult to accurately assess the validity of the ESG scores. We explore these shortcomings within this thought piece, along with the challenges they present to issuers and investors.

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1. Source: Plan A – MSCI 2020 Deconstructing ESG Ratings Performance Risk and Return for E, S and G by Time Horizon, Sector and Weighting

Small-cap companies are often overlooked by ESG Ratings Providers

Small-cap companies are often overlooked by ESG performance raters because of the limited disclosure generally provided by these businesses, coupled with an inherent bias toward large and mega cap companies. This presents a unique challenge — and opportunity — for those of us who invest in the small-mid cap sector.

The fact that ESG performance data, unlike financial data, is not standardized, audited, readily available and widely disseminated means it may also not be accurately factored into the valuation of a company. Just as market dislocations create buying opportunities, we argue that “rating dislocations” are a way for knowledgeable investors with a proprietary view on ESG risk to add value and de-risk portfolios.

While third-party ratings systems have their place in ESG assessment, we believe that comprehensive and meaningful analysis can only be achieved if two components are in place:

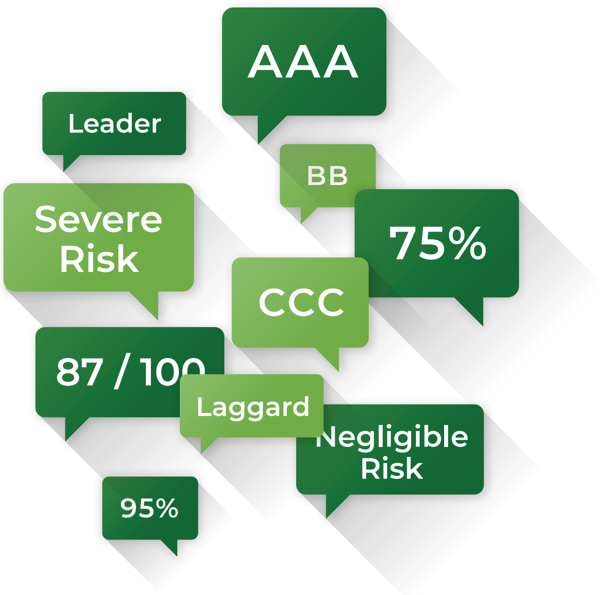
One is that asset managers must develop and manage their own ESG framework and assessment process. Third-party services can, and should be, one input to this process.

Second, engagement with corporate issuers is central to the fulfillment of the framework and to meaningful progress on ESG.

In our view, the only way to meaningfully assess ESG risks and their potential impact on a company is to truly understand the business and engage with management regarding their perspective of risks to the business. We will explain how we have adopted this two-pronged approach, along with examples from our portfolio.

CURRENT CHALLENGES IN ASSESSING ESG PERFORMANCE

The False Precision of Subjective Analysis



By definition, ESG performance measurement is a complex and subjective process that cannot be fully captured by data. Looking at the factors most common in calculating a company’s ESG rating (see Figure 1), some are broadly defined and impossible to put a number on. And yet, the output of the ratings agencies is a specific ESG score. This “false precision” can give investors a false sense of confidence (or judgment) about a company’s ESG credentials.

While an arbitrary score may be sufficient if one is merely looking to check the box on ESG, we’re trying to understand and manage risk in our portfolio. We would not be comfortable making decisions based on ratings alone.

FIGURE 1 | **COMMON ESG RATING CRITERIA** [2]

ENVIRONMENT

- GHG Gas Emissions
- Air Quality
- Energy Management
- Water & Wastewater Management
- Waste & Hazardous Materials Management
- Ecological Impacts

SOCIAL

- Human Rights & Community Relations
- Customer Privacy & Data Security
- Access & Affordability
- Product Quality & Safety
- Customer Welfare
- Selling Practices & Product Labeling
- Labour Practices
- Employee Health & Safety
- Employee Engagement, Diversity & Inclusion

GOVERNANCE

- Business Ethics
- Competitive Behaviour
- Management of Legal & Regulatory Environment
- Critical Risk Management
- Systemic Risk Management
- Product Design & Lifecycle Management
- Business Model Resilience, Supply Chain Management
- Physical Impacts of Climate Change
- Board Structure
- Executive Compensation
- Shareholder Rights

No Authoritative Reporting Standards

While efforts are underway to streamline ESG reporting, the explosive growth in the number of companies providing research, ratings and data has led to confusion for investors and investee companies alike.

In a recent survey by Duff & Phelps, participants reported using 14 different combinations of ESG frameworks — most of which are not consistently comparable or easily verifiable.[3]

What's more, because the ESG rating systems are proprietary and commercially sensitive, their owners are reluctant to provide transparency about what goes into the "secret sauce" — making it difficult for investors to assess the validity of the data.

Low Correlation Between ESG Rating Agencies

The proprietary approaches employed by ESG ratings agencies also result in conflicting opinions.

Case in point:

3M, a multinational conglomerate corporation that provides diversified industrial products, is ranked top quartile by one agency and rated poorly by another. While these two agencies may disagree, neither can be considered wrong. Each agency focuses on different sets of data. One relies on corporate disclosure, while the other employs AI algorithms to capture sentiment from unstructured data — thus underscoring the idiosyncratic nature of ESG ratings.

2. Source: Sustainability Accounting Standards Board (SASB), Laurus
3. Source: https://www.kroll.com/en/about-us/news/esg-reporting-system-effective-esg-disclosures

A recent paper from Massachusetts Institute of Technology examined the different ESG scoring systems and found only a roughly 40% correlation across the scores. Contrast this with the trusted and consistent methodologies of credit rating agencies (e.g. S&P and Moody's) where correlation is 97% and one can see why it's difficult for investors to be fully comfortable basing their decisions on ESG ratings alone.[4]

Greenwashing

Corporate issuers can choose to selectively disclose their sustainable practices. Given that some companies may simply be effective at gaming the system, it remains the responsibility of active managers to poke around under the hood to understand whether the data and conclusions are valid.

THE PROBLEM WITH SMALL-CAP ESG ANALYSIS

The weaknesses found in ESG performance reporting become even more complex when you layer on the unique challenges germane to the small-mid-cap universe.

Lack of Disclosure by Small-Cap Companies

Large-cap and small-cap companies are clearly at different stages of ESG disclosure adoption.

Tara Patok, a Partner at William Blair & Company recently wrote that 90% of companies in the S&P 500 has issued sustainability reports in 2019. However, when measuring the bottom 500 companies in the Russell 1000, this number dropped significantly to 39%. Noted Patok, "*One can safely assume the percentage would diminish further for small-cap companies, and our own anecdotal evidence suggests this is true.*"

We would agree. There are at least two reasons why this is the case.

1. COST

It is a costly endeavour for smaller companies to track and report ESG progress. Even large-cap companies are known to complain of "survey fatigue", groaning under the weight of information requirements by various ratings agencies. For most small-cap companies dedicating the resources required to participate is not an option. Costs may include expenses related to the measurement and analysis of data, hiring dedicated employees to report activities, and costs of implementing sustainability strategies. For a small business, the heavy burden could turn a net profit into a net loss.

2. EARLIER STAGE OF ESG ADOPTION

The fact that a small-cap company doesn't report on ESG, doesn't necessarily mean that its management team isn't aware of or managing ESG risks in their business.

Sustainability risks are frequently emerging as a small-cap company grows. These companies are often nimbler, allowing them to react to risks as they arise. Fundamentally, they may be in a better position than a large-cap company that has well-documented ESG risks but difficult to manage because they have been deeply infused into the company's culture.

While 90% of S&P 500 companies issued sustainability reports in 2019, only 39% of the next largest 500 companies did so.

4. Source: https ://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/why-esg-is-here-to-stay

Lack of Coverage by Ratings Agencies

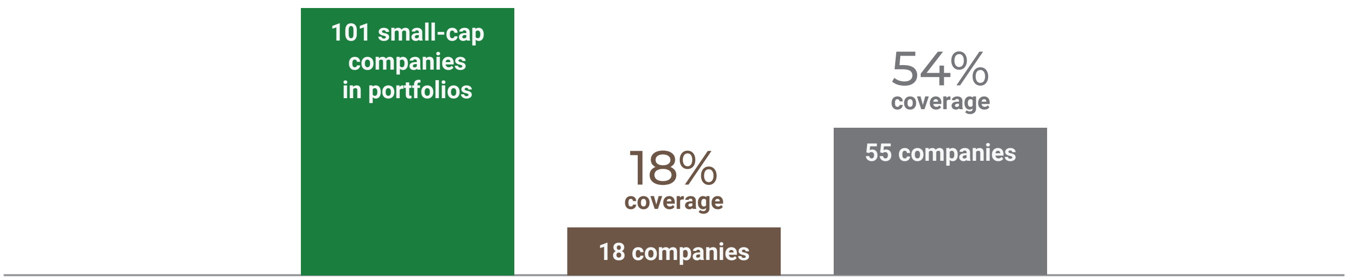
The universe of ratings coverage favours large-cap companies. While there is no recent and reliable data on the breadth of coverage of the small-cap asset class, our own portfolio may serve as a proxy, as shown in Figure 2.

Of the 101 small-cap companies held by Laurus at the end of 2021, only 18% were covered by one major rating agency.

Investors are also often forced to choose between breadth and depth of analysis when evaluating ESG data providers.

One would believe the logical solution to be to subscribe to multiple ESG data vendors. If a company is not covered by one agency, then go to the next. While this solves the breadth problem, one is still dealing with inconsistent ratings between providers and their proprietary scales.

FIGURE 2 | **ESG RATING AGENCY COVERAGE ACROSS THE LAURUS SMALL-CAP PORTFOLIOS [5]**



RATING AGENCY A
In this example, rating agency A employs a disclosure- based approach, relying on company management to support their ratings. This process typically generates deeper insights but is limited to a smaller universe of coverage, as evidenced here. The result is that some well-managed companies providing limited ESG disclosure are overlooked.

RATING AGENCY B
By contrast, rating agency B provides a more comprehensive coverage of the universe (54%) but their predictive quantitative models can lack depth and accuracy.

A TWO-PRONGED SOLUTION

An oblique outcome of investors' newfound concern for ESG issues is that, arguably, the industry itself is being pushed into the process of becoming better investors. W. Edwards Deming, the admired writer on quality and business, was quoted as saying "What gets measured gets managed." As such, identification, measurement, and discussion around potential exigent risk goes hand-in-hand with fundamental, long-term investing.

> We contend that to derive true ESG insights, small-cap managers must build and manage their own analytic models. They must also engage with company management to confirm and contextualize their insights.

5. Source: Laurus Investment Counsel, as of January 31, 2022

1 Build & Manage Analytic Models

While it may seem daunting to assess a small cap business's ESG risk exposure, fundamental equity investment managers are best positioned to make the judgement should they choose to make it core to their process.

ESG assessments must be grounded in company-specific risks, their materiality and the company's handling of them. We believe this can only be achieved through an internal analysis framework.

An example from our portfolio illustrates this point:

The rating agency classified one of our investments as a toy company, and assessed its ESG performance on the material risks for a company in that industry.

However, as long-time investors, we knew that the company also creates media content and operates an emerging digital gaming platform, giving rise to a different set of risks, such as customer welfare, privacy, and data security.

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2 Engagement with Management

The second component that is necessary for meaningful ESG insights — particularly in the small-cap universe — is engagement with company management.

With a robust understanding of the risks and by engaging with management, responsible investors have a role to play in helping to increase the rate of adoption of sustainable business practices more broadly.

In addition, an analyst who has a deep understanding of a company's business model and growth strategy, can also anticipate emerging ESG risks — and work with management teams to mitigate them. By contrast, rating agencies are using post facto information and are not focused on identifying future risks.

LAURUS' ESG APPROACH

As a firm, we are a signatory to the UN Principles for Responsible Investment and are committed to incorporating ESG factors into investment decisions and active ownership.

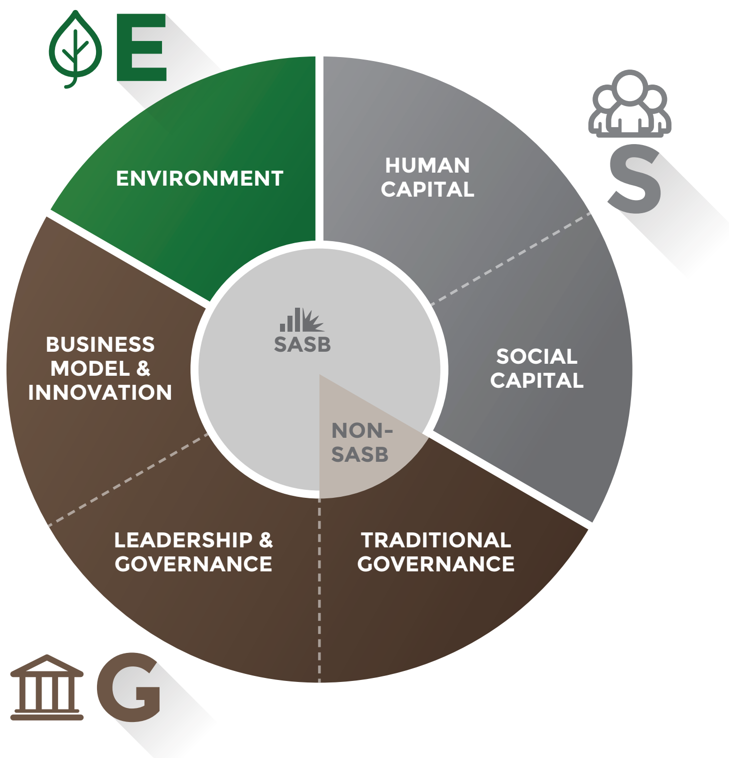
Dedicated ESG Committee

Our ESG Committee is led by a Senior Portfolio Manager and reports to the Investment Committee. The ESG Committee is responsible for developing the policies, processes and tools to allow us to deliver on our responsible investing commitment. To ensure accountability to our policies, our Chief Compliance Officer also sits on the ESG Committee.

Proprietary Framework

We spent three years building our evaluation methodology that is based on the principles of materiality and risk management. Our process is informed by the Sustainability Accounting Standards Board (SASB) ESG framework. We then supplemented SASB standards with our own internal evaluation criteria. SASB ranks ESG issues by industry which is the starting point and helps us to prioritize our proprietary analysis.

In essence, what SASB does is give us a series of ideas about the particular risks to which a given company may be exposed. We then go well beyond those ideas, to explore and analyze. The research output is then incorporated into decisions that drive engagement activities and portfolio construction. It is a process we have fine-tuned over several years and are continuously improving.



Quality Analysis

Having built our own set of materiality risks we fully understand the methodology that informs our framework — and our decisions. The quality of our ESG analysis is an extension of the quality of our fundamental investment process. We own the analysis; we own the decision. And we are accountable to clients who have a genuine commitment to ESG wanting to look behind the risk ratings and have a discussion about the conclusions.

It also means that our proprietary view of ESG risk will sometimes differ from that of the ratings agencies.

For example:

We have an investment in a Finnish health care device company that is a global leader in ophthalmic diagnostics and is rated "high risk" by a reputable ESG ratings provider. Due to the small market capitalization of the company, we noted that the ratings provider has used an abbreviated methodology, which employs a more limited range of indicators to assess the company. Additionally, it appears that the rating assigned to the company is due in part from the company's categorization as a health care company. While we are cognizant of the potential ESG issues investing in medical device manufacturers, through our deeper analysis of the company, we concluded that the nature of the company's products and business model meant that many of the typical risks associated with the sector such as product quality, affordability, selling practices, and business ethics are much less relevant in this case.

Engagement with Management

The level of engagement with company management has long differentiated us as money managers. Over the past several years, we've extended that engagement to include ESG: identifying, exploring and verifying ESG risks with the management teams in our portfolio companies. And as significant investors with concentrated positions in these small-mid-cap companies, we have a direct line to senior management.

PROVIDING GUIDANCE

In our conversations with management, we don't try to be prescriptive. We are, after all, active managers, not activists. But we do provide guidance as to improvements we would like to see as our portfolio companies grow.

For example:

A few years ago, a financial services business expressed the desire to expand its Board of Directors. We saw an opportunity to promote diversity and put forward a qualified female candidate that was ultimately selected. Today, the 13-member board is comprised of six female directors.

Sometimes our guidance is through sharing best practices and identifying new ideas for management to consider.

SHARING BEST PRACTICES & NEW IDEAS

Sometimes our guidance is through sharing best practices and identifying new ideas for management to consider.

For example:

We own a supply chain technology business that has an ESG focus and produces a sustainability report that goes beyond the standard disclosure to include discussion on their ability to support their clients' ESG efforts by reducing waste and improving sustainability.

In reviewing that report, we recognized similar business characteristics between that company and another of our holdings, a digital forensics company. We then approached the forensic business' management team and pointed out opportunities to highlight their sustainability attributes, which they had not previously identified.

Ratings Linked to Outcomes

It is essential to tie an ESG performance assessment to a result. In other words, the risk rating we assign to a company must have implications for its position in the portfolio.

MANAGED MATERIAL RISK

If a material risk has been identified and it is being managed, it may result in a low-risk rating for the company.

Case in point:

We own a technology company that provides services to the oil and gas industry. On the surface, it may invite a high-risk rating. However, the company's services increase drilling efficiency and improve safety, thereby leading to improved ESG performance of its customers. In addition, the company's management team has recognized the need to diversify its business. Several years ago it began investing in electrical energy storage and other energy management technologies. Consequently, it has a low-medium risk rating within our framework.

UNMANAGED MATERIAL RISK

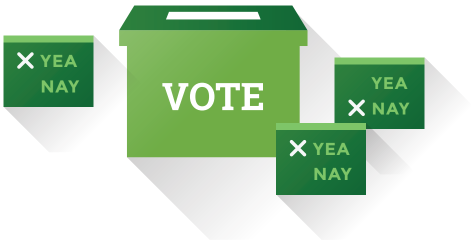
If, on the other hand, we have identified a material ESG risk that the company is not managing, this is a red flag. The position is then exited or reduced according to the policy.

Case in point:

A large and long-held telecommunications position was recently exited because of elevated governance risks that resulted in a rating change from low to high.

Proxy Voting

We align proxy votes with engagement priorities. A large proportion of small-cap companies are led by founders who retain control despite being a publicly listed company. As a result, their boards often lack diversity and independence. While this does present the case for weak governance, it is frequently balanced by the founder's significant wealth being tied to the success of the company. As the business grows, there will be a need to expand the board's expertise and diversity, and we can influence change with our votes.



Ongoing Assessment & Oversight

Existing portfolio companies are reviewed annually or whenever there is a material change — such as an acquisition. For small cap companies growing at a rapid pace, the risks are evolving all the time. With every acquisition, new business opportunity, or geographic expansion, a new set of ESG risks emerge.

The pandemic accelerated the adoption of technology and cloud data management within many companies — leading to potential new ESG risks that we need to evaluate. For example: a company may now be exposed to greater cyber risk. Does the company have policies in place to make sure data doesn't get exploited? From a social perspective, there's a risk that is now there that wasn't there before. It's a continuous process of analysis and interpretation.

CONCLUSION

In summary, our investment approach embraces a committed and comprehensive analysis of ESG factors.

As quality growth managers, we search globally to invest in strong, entrepreneurial small and mid-cap businesses with sustainable competitive advantages.

Using an approach similar to private equity, we conduct deep fundamental research, constructively engage with management and take a very long-term investment view to each investment.

These are the factors necessary for robust ESG analysis and engagement from which everyone benefits in the long run.

THE LAURUS APPROACH: DIG DEEP, OWN LONG

Focus on Quality

We invest in small-cap companies that have high-quality income statements and balance sheets and have the capacity to grow disproportionately.

We define quality in three ways:

ABILITY TO SUSTAIN HIGH RETURNS ON CAPITAL	REPEATABLE CASH FLOW GENERATION	LIMITED EXPOSURE TO FINANCING RISK

Original Viewpoint

Based on our proprietary research process, we inherently believe we know our companies better than other investors. We seek to develop our own original viewpoint for every company we invest in. We may consult conventional research sources for idea generation, but the rest of our process is independent, painstaking, and iterative based on analysis by our diverse team including in-depth discussions with company management and external experts. Our research and due diligence process rivals that of a private equity investor.

Concentrated Portfolios

From the vast universe of global small-cap companies, we focus on finding the best 1%. Our portfolios consist of approximately 25-35 names that we will know well and own for a long time. Our average annual turnover across our small-cap portfolios is less than 25%.

Steadier Returns

Our process has proven that a concentrated portfolio of higher-quality companies within the asset class will result in lower volatility and less downside capture than a traditional portfolio of small-cap stocks.

ABOUT LAURUS INVESTMENT COUNSEL

Founded in 2014 and based in Toronto, Canada, Laurus is an employee-owned fundamental investor, searching globally to invest in strong, entrepreneurial small and mid-cap businesses with sustainable competitive advantages. Using an approach similar to private equity, Laurus conducts deep fundamental research, constructively engages with management and adopts an uncommonly long-term investment horizon to each investment. This process has proven to deliver quality returns with lower volatility over multiple market cycles for our institutional clients.

DISCLOSURE

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