PODCAST TRANSCRIPT

Shareholders Drive ESG Improvements

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What we're seeing is that shareholders, such as ourselves, are starting to let management teams know that environmental, social and governance (ESG) standards are important. Senior Analyst Dan Sheridan discusses how investors' increasing focus on ESG is driving companies to make significant, long-term changes.

ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to The Alger Podcast: Investing in Growth and Change. In our last podcast, we spoke to Portfolio Manager Greg Adams about how Alger has been addressing investors' increasing interest in companies that are improving their ESG–or environmental, social and governance–standards. As we continue with that topic, I'm speaking with Alger Senior Analyst Dan Sheridan, who's been actively working with Greg and other team members to develop our new, comprehensive ESG guidelines. Dan, thanks so much for joining me this afternoon.

DAN SHERIDAN: Thank you.

ALEX: Dan, you've been with Alger a couple of years now. Is ESG something you were focused on in your earlier experiences?

DAN: Not really. I knew of ESG and found it interesting but didn't have a deep background of employing it in any research process. It wasn't until I came to Alger that Dan Chung, the CEO, suggested that he really wanted to make a concerted effort to start to employ ESG principles in our own investment process. He basically asked for volunteers of who would be interested, first, and then a bunch of us said we would be interested, and we went through a bit of a vetting process as to who was going to be the leads in setting up our methodology, particularly on the research side.

ALEX: So, as you started to develop those guiding ESG principles, what did you think about? What kinds of things did you want to change or evolve?

DAN: What we tried to do is say, What are the principles that we want to employ? What are the things we want to start to incorporate into our own process so that we can take our other funds to not only a point of looking for great stocks but making sure that those companies are scoring well on a whole host of ESG principles?

In addition to that, we really wanted to start the research process down the path of understanding what these principles do for long-term stock returns, and is there a correlation to companies that do good in the world and are socially responsible and their overall stock performance? So, our goal was to marry those two things and to start a research process and a methodology that would allow us to, one, start to monitor and observe those things that I just talked about but then also engage with the companies on a very deep level so that we could start to rank and score and create reports on ESG companies.

Alger is a very, very research-focused firm. It does deep fundamental research, and we wanted our ESG effort to mirror that such that it was very, very similar to how we approach our individual equity research.

ALEX: Did you find that correlation – between stocks performing well and ESG principles?

DAN: Much too early to tell at this point, and there's a lot of literature that has been written about this, and that literature isn't quite sure either. It seems to be that, yes, there is a correlation to good ESG principles and outperformance. Our effort is just a couple years old, and we don't have enough data yet to make that assertion.

Logically and from a common-sense perspective, it makes sense, and we've seen many examples of where companies are doing things that score quite well on ESG metrics and also lead to a real positive view of the company, whether it's by consumers or stakeholders or what have you and customers. So we've seen that anecdotally.

DAN: But we don't have enough data yet, but what we've done is we've started to rank the companies on some of their change factors. Alger follows a process on the fundamental research side where we're looking for companies that are undergoing dynamic change of some sort. What we do when we engage with any of our ESG companies is we rank them on a change score and awareness of the issues, the magnitude of potential change and the likelihood of change happening in the next year, and we score them. We have our own internal scoring system.
And what that is, is the beginning of a database where we can look back and, one, see the movement in our scores for these companies but, two, also measure that and monitor that, utilizing a database and scores over time and then obviously the performance of that particular equity.

ALEX: Can you walk us through some of the guidelines you and the team use when you're looking at a particular company?

DAN: What we do is we assess what issues the company has from an ESG perspective, both positively and negatively, and then what we try to do is we try to dig into the negative issues when they exist and really understand what the reasoning is behind those issues and then engage with the company to see, one, are they even aware that they're being viewed this way and, two, if so, do they have any plans to change it?
It's interesting because ESG, although it's been around for a while, is a relatively new concept for a lot of companies and management teams. When we talk to them, we'll always ask them, are you getting other inquiries such as this from other companies? They'll say much more so in the European theater and much less so in the U.S., although the focus in the U.S. has doubled more or less in the number of inbound inquiries that they've gotten over the past year or two. It's obviously starting to gain traction here in the U.S., not quite where it is in the European theater, but it is moving in that direction.

ALEX: And how do you grade different companies? That is, how do you decide who gets an ESG pass versus a company you may need to further engage with?

DAN: Well, when we set up our structure, again, we wanted to create something that we felt would be most impactful, and what that meant was that we wanted to look at the top 75% of our firm's AUM. The reason we chose that cutoff level was because those are the companies where we own the largest positions, where we have the longest-term period of owning those stocks and where we felt we could really make a difference in engaging with the management teams because we are relatively large shareholders of those positions. It also tends to be the positions that we're likely to hold year in and year out as long-term investors.
What we do is we take that 75% of AUM, and we put it through a screen once a quarter, and we're looking for the scores that are above 25 in the Sustainalytics ranking. Sustainalytics rankings are structured that scores that are lower are better. Scores that are higher are worse, and we wanted to find a level where we thought that the score was indicative that the company needed to make change. Most companies under 25 are doing a really good job or have already recognized that they need to improve on some of these ESG issues, and they have, and we want to spend the disproportionate amount of our time dealing with the companies who are either scoring poorly or really need to make a change. That's allowed us to put more effort and more time in those companies that need to make some moves.

ALEX: And I understand you've engaged with several companies, and some of the responses have been quite significant.

DAN: Yes. Our best example is a large semiconductor company that we engaged with last year. And it's a company that we've known for a long period of time and have owned for a while. As part of our process, we reached out to them and brought up a number of issues that we felt needed to be addressed, and the company was very open.
And much like we hear with a lot of companies, this is new to them, and in many instances they are doing some things that are positive, but they don't have disclosure that indicates as such. In other instances, they just didn't realize that they scored as low as they did and sometimes it's just putting their peers' processes into light for them so they can see, Oh, wow, that company is doing that better than we are. In this particular instance, our engagement led to the company essentially creating a committee internally to address some of the ESG issues that we brought up and, again, that's a really good news story where our engagement led to something significant being done, and we kind of know that happened directly because the company reached back out to us and said, "You guys have facilitated this," and so that was quite gratifying.

Dan (continued): Incidentally, the Sustainalytics score improved markedly this year which is, again, another indication that, hey, it worked, and we really made a difference in this particular case.

ALEX: You also mentioned a consumer company that you were very positive on. Can you talk about that company?

DAN: Yes. There was a consumer-oriented company in the coffee space, and one of the things we really dug into is what they did during the pandemic, and the COVID pandemic was a great example of where companies were having to make some major, major decisions about a whole host of factors that fall under the ESG principles. In this particular case, we were very pleased to see that this company went above and beyond to take care of their employees during this period, to make sure they were safe, to close more stores than some of their peers did very early on when COVID started to become known across the U.S. They also paid bonuses for those that were working in certain regions, and we think that's going to have profound benefit to how this company comes out the other side of the pandemic because we live in a very social environment where people score things on social media and where information is very readily available, and when companies do good by their customers and when companies do well by their employees, that engagement improves among customers, and we've already seen some instances of that.
So, this is more than just doing good. It's also following smart business practices which may cost you in the short term. This company was paying more salaries over a couple quarters than many of their peers. We think it will lead to significant long-term benefits on a multi-year basis to the revenue and cashflow lines.

ALEX: Dan, currently there's no type of corporate obligation for companies to improve their ESG scores. Do you think we ever get to a point where there is some sort of corporate requirement?

DAN: Well, the companies are starting to see pressure from their shareholders, and if the shareholders care, the companies will start to care, and this is really a grassroots effort on the part of shareholders. But what we're seeing is that shareholders such as ourselves are starting to let management teams know this is important, and you're already starting to see decisions made to potentially own stocks and not own stocks based on this behavior. Obviously, that leads to companies caring a lot.
So, I do think it will become increasingly more of a focus from company managements going forward and I think that the trend is probably just beginning. We're in the early stages of this even though ESG has been around for a while. The groundswell of support and real focus on it has really started to uptick over the past several years and, to me, this is closer to the beginning rather than the end.

ALEX: Dan, thanks so much for your time this afternoon.

DAN: Thanks, Alex. Great talking to you.

ALEX: And thank you for listening. For more information on Alger and ESG investing, and for more of our latest insights, please visit alger.com.

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