NOMURA ASSET MANAGEMENT U.K. LTD.

The Philosophical Thoughts of a Responsible Investment Team

The Global Equity Team

Published July 2020
by Nomura Asset Management U.K. Ltd.

Introduction

At Nomura Asset Management we have thought deeply about Environmental, Social and Governance (ESG) and Responsible Investing and, herein, share our opinions, principles and frameworks. We consider the logic and also the psychology and rather than basing an argument on the belief that ESG will be an outperforming strategy, we conclude that it is first and foremost **the right thing to do** and you should **always start from there**.

We believe that responsible investing is the process of giving consideration to the total impact of an investment decision on all stakeholders, not only the end investors (our clients) but also customers, suppliers, employees, competitors, broader society, the environment and ourselves.

NOMURA

Why incorporate ESG research at all?

The Logic

Integration of ESG into investment decision making is increasingly accepted

There is an increasing acceptance that investment decisions should be made with consideration to their long-term impact on the World, not just their near-term financial results. ESG and other non-financial factors are being assessed as part of overall investment processes, but although opinions on specific ESG issues are often hotly debated, the motivation for even having an opinion or taking action are less well explored.

An argument that it brings better returns has emerged

Often “doing ESG” is touted as a route to generating superior investment returns, linking the ultimate success of a business to its sustainability. Leaving aside the validity of investment logic, the statement certainly has appeal. It fits the simple and well accepted “Incentive Theory of Motivation”, which suggests behaviour is motivated by incentives or the oft adulterated version that focuses on financial incentives. As Berkshire Hathaway’s Charlie Munger says “Show me the incentive and I’ll show you the outcome”.

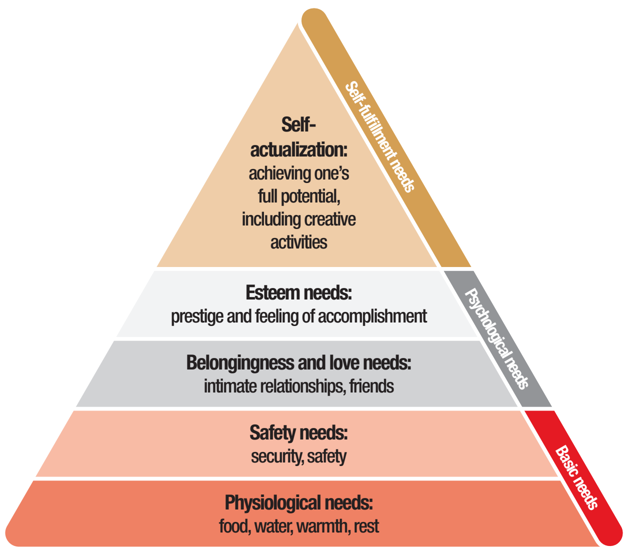
But what if ESG did not enhance returns?

Although we do not necessarily disagree with the hypothesis that the ‘good ESG’ companies should out-perform the ‘bad’, it is healthy to question this Machiavellian motivational logic. Certainly good corporate governance or high standards of operational and product safety for example should, intuitively, lead to good investment returns and Nomura Asset Management’s own back-test data suggests this might well be the case.

The Psychology

Maslow’s Hierarchy of needs can help us to address this

Maslow’s “Hierarchy of Needs” is a well-known and useful framework for assessing the relative importance of motivational factors. In the hierarchy, financial outcomes serve predominantly to meet “Basic needs”. Once these are met, the incentives relating to “Psychological needs” and “Self-Fulfilment needs” take precedence. Of course, for many, financial incentives cannot easily be disentangled from the feelings of accomplishment and fulfilment, but it is clear that non-financial factors are the main driver of ‘higher order’ needs.



Responsible Investment meets a ‘higher order need’

Hence, in the Hierarchy of Needs we find a motivational logic for incorporating ESG matters into investment processes that is quite apart from, and arguably more powerful than, that of financial incentives. Whether ESG has efficacy as a driver of investment returns or not is irrelevant to its efficacy as a fulfiller of ‘higher order needs’ such as contribution to family/community, respect of and by others, accomplishment, the achievement of one’s potential, creativity, etc.

And so should be integrated regardless of any enhancement of returns	At Nomura Asset Management we find a simple answer to the question of what to do should we conclude that ESG has no significance to investment results. Firstly, we believe our investment analysis and stock-specific decision making will continue to deliver superior investment returns, not the simple exposure to certain investment 'factors'. Secondly, we believe our ESG related activity offers a contribution to meeting the 'higher order needs' of our clients and ourselves. In short, this work is just the "right thing to do", not simply as a means to an end and so should continue unchanged.

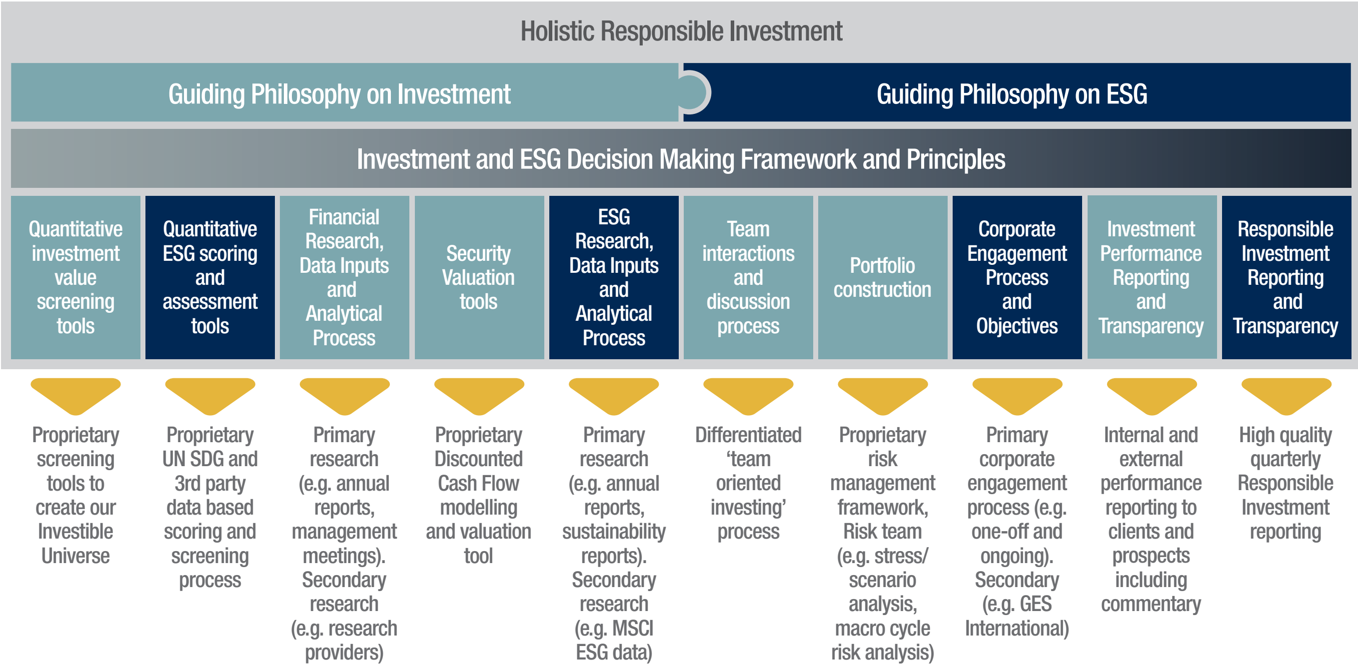
A Framework for Responsible Investment

Competing responsibilities can make for difficult investment decision making	We are responsible for the outcomes of the decisions we make. In investing one outcome is the subsequent actions of our investee companies, so we must be responsible for those. To not be would, surely, make us irresponsible investors. Complexity arises from our role as 'agent owners' rather than actual owners, where the agency mandate typically focuses on investment results. Our responsibility for company actions (such as excessive and unabated carbon emissions) may or may not coincide with our responsibility to deliver good investment results to clients, the actual owners. In some instances the long term detrimental impact on corporate value creation due to its irresponsible or socially unacceptable behaviour creates alignment of those responsibilities, in other instances specified client priorities create such alignment. Much more often the situation is ambiguous. How then to act responsibly in the face of multiple and potentially misaligned responsibilities?
Utilitarianism provides a decision making framework	Jeremy Bentham, the nineteenth century philosopher proposed that to measure the rightness or wrongness of a decision depends on the outcome bringing the "greatest happiness of the greatest number". This is the underlying principle of Utilitarianism and we have applied this to the challenge of investing responsibly. In other words, to judge what we should and should not invest in, we must assess the wider utility derived from our investment decision.
Consideration of Total Value created for all stakeholders is key	Responsible investing is the process of giving consideration to the total impact of the investee corporations on all stakeholders, not only the end investors (our clients) but also customers, suppliers, competitors, broader society, employees, the environment and ourselves. Our starting point, as responsible investors, therefore is to think about the total utility or Total Value created by our investee or potential investee companies. The Total Value created is not just financial but the benefit delivered to all stakeholders, including the happiness brought to customers, the employment and growth opportunities brought to employees, the impact on the environment, etc. For example, we might apply this framework to a possible investment in a business that uses monopolistic pricing power to hike lifesaving drug prices more than 50x, to almost entirely unaffordable levels. The stakeholders in this decision clearly include the end investors (our clients) and the customers who need the drug. The end investors may wish for high investment returns and would thus be happy with such corporate behaviour, but what about the severely detrimental impact on the customers? Consideration of these stakeholders leads us to conclude that the total utility would not be enhanced by the investment and therefore we should not invest. This is our view. Or put another way we should not make investment decisions that cause an overall reduction in utility to all stakeholders including, but not limited to, shareholders. So it follows that we should invest in companies, and make investment decisions, that increase the Total Value to stakeholders at large.

Fair sharing of Total Value is aligned to long term sustainable investing	To achieve long-term returns for our clients we, of course, seek to invest in those companies that can sustainably create significant value. However, even if the Total Value creation is positive, sustainability cannot typically be achieved if the value created is not fairly shared among the various stakeholders. In our drug pricing example for instance, in the short term, hiking prices allowed the company to dramatically increase its share of the value created by the drugs it produces, to the benefit of shareholders. But such price increases sparked a political and regulatory backlash that ultimately backfired on the industry. Dramatically increasing the price of drugs that have been in production for years did not create extra value in the broad sense, but did allow the company, for a short period, to capture a much larger share of the value that was being created already.
Fair sharing is also an area where we can make an active contribution	History suggests that there is a broad band, within which a company can operate, where all stakeholders are satisfied 'just enough' by their share of the Total Value creation, even though the impact on certain stakeholders might be far from optimal. Movement outside of that 'fair sharing band' tends to lead to a sharp correcting force, bringing the value share back to a fair or equilibrium level. Put differently, companies can continue to generate sustainable long-term returns despite certain stakeholder groups being negatively impacted by the company's operations, especially where the stakeholder has no strong advocate. This is an example of where we believe our corporate engagement activity can make an active and positive impact on corporate behaviour.

Implementing in Practice

The proximity of ESG analysis and the investment decision making is vital	Since the consideration of ESG matters can contribute to meeting the 'higher order' needs of our clients and also ourselves, as investment professionals, it follows that the people making the investment decisions should be the ones who conduct the ESG analysis. Of course we must accept capacity or specialist knowledge limitations, but judicious use of third party data and research, within an investment team's clear philosophical framework, ensures ESG is fully integrated into the investment process. Having all the inputs in one place is a clear positive for decision making generally and, similarly, the proximity of investment analysis and decision making tends to produce better investment outcomes. Therefore, proximity of ESG related analysis and ESG decision making should similarly produce better ESG outcomes.
As is the intellectual infrastructure of clear philosophies, processes and tools	Consistently good decision making is key to long term investment success. As we have seen, proximity of analysis to decision making has proven benefits, but additionally a variety of tools and processes are required to support consistent information collection, analysis and assessment. The close interaction and alignment of specifically ESG and the more traditional investment decision making processes is key. Indeed, the combination of investment and ESG decision making philosophies, processes and tools into one decision making operation could be considered the hallmark of a truly integrated Responsible Investment approach.



Different stakeholder groups will assess 'Total Value' in different ways

Within a decision making group the affiliation with and advocacy for certain stakeholder groups will undoubtedly cause their perspective to be brought to the fore. Clearly we, the investment professionals, are stakeholders and also the decision makers, so could our own ethical position, inadvertently, carry too much weight? Indeed should personal ethics or opinion on the actions of a company have an impact on the investment decision making process? And if our opinions are relevant then how should we weigh the impact on different stakeholders and make an assessment on whether this balance is adequate to allow investment in the company? Investment decision maker opinion is crucial to the purely economic matters of investment so why not for matters of ESG. However decision making consistency is again key. Proximity of decision making and decision inputs is useful in handling nuanced scenarios, especially when combined with a comprehensive suite of philosophies, tools and processes. Well understood information inserted into such an operation is likely to produce well considered and consistently good decisions.

An example might be a decision on investment into a company that is expected to financially outperform a peer, but clearly has a greater impact on the environment through higher CO_2 emissions and looser internal policies. Many of us believe strongly in limiting our personal impact on the environment, but when it comes to our investment decisions how should this be incorporated in the decision, if at all, and, in any case, what is the relative importance of the environment and broader society compared to attractive investment returns?

Our practical implementation of Utilitarianism allows different emphasis on different stakeholders

Utilitarianism, including ourselves in the stakeholder group, can help. In essence we can prioritise the different stakeholder groups and then assess the negative or positive impact that our investment decision (for example in an environmentally damaging company) would have on each stakeholder group. Then, in theory, a simple priority weighted average of the stakeholder impacts should tell us whether, in aggregate, we should or shouldn't make the investment. However as Yogi Berra once said, "In theory there is no difference between theory and practice. In practice there is." There is often no clear cut answer as to the impact on different stakeholder groups, and personal ethics clearly vary from person to person. Moreover we need to consider the issue of 'moral relativism', that is an ethical action from one perspective might seem unethical from another perspective. This is where our personal ethics can help and whilst we cannot apply the ethics of someone else, we can add a broader ethical viewpoint in an investment decision making context.

Implementing this for impact

The traditional view of impact investing has overlooked public companies	The traditional view of impact investing has been built around the concepts of clear intentionality and the measurement and attribution of environmental and social impact to a specific allocation of capital. This has quite reasonably meant that smaller scale private debt and equity has been the primary focus for those seeking to have 'impact' wherein the ability to measure and attribute any impact to an investment is less complicated. Large public companies typically have multiple operations, not all focused on one specific environmental or social outcome and they often do not report data specific enough to the operations in order to clearly track the impact outcome.
But that is a mistake	The UN Sustainable Development Goals (SDGs) established the 17 most important Goals for achieving a sustainable future for our planet and a number of the goals are clearly best served by direct private investment, but what about targets centred on eliminating disease or increasing the penetration of renewable energy? Large public companies play perhaps the most important role through the commitment of unparalleled levels of capital and resources to researching & developing solutions and practically delivering them. Be that multibillion dollar offshore wind farms or strategies to ensure those most in need can access expensive drugs. Indeed a relatively small portion of a large company is often far bigger than the whole of a smaller 'impact' investment. Should these companies be considered unsuitable investments for achieving 'impact' simply because intentionality cannot be as clearly defined and impact cannot be attributed as directly? How too should one think about the 'impact' of huge companies that are using their power and influence to bring about positive change even though it is not core to their operations? A number of large US tech companies have led a mini industrial revolution by committing to renewable power and pressuring supply chains to adopt similarly responsible practices. Whilst not being their core operations the companies are having a huge positive environmental impact as evidenced by the staggering amount of renewable energy being commissioned. The actual impact of this is vastly greater than for example a direct investment in a small company that is researching new solar technology, it is just not as clearly attributable and cannot be claimed as intentional. Microsoft, for example, is aiming to be carbon negative by 2030 and by 2050 to have absorbed all the carbon it has emitted since its inception in 1975. Based on company reported information we can estimate that to date Microsoft has emitted over 170mn tonnes of carbon which is roughly equivalent to a current US coal fired power station for one year. So although clearly not a primary objective of the company Microsoft can have a sizeable impact on carbon emissions and quite probably a more sizeable than much smaller companies specifically targeting emission reductions. So although perhaps not themselves 'impact investments', clearly companies like Microsoft are having a huge positive impact and that impact should not be overlooked. Not only do large companies have the resources and investment power to address the huge issues facing society but they are typically the best managed and most efficient allocators of capital. Hence they offer an interesting way to achieve positive impact and also good investment returns. Moreover as institutional investors we have the collective ability to direct companies to support SDG outcomes and even small changes by them can have huge impact in dollar terms.

Tracking impact is important and can be an issue for large companies

The issue remains, however, as to how to track the impact of large and complex companies especially when it is not the entire company that is specifically impacting a certain goal or even the 'intention' of the company is not specifically to impact the goal at all. We have developed a framework to do this. Upfront clarity of goals and a thorough analysis of the route to achieving those goals allows impact to be credibly measured, tracked, reported and acted upon as necessary.

Nomura Asset Management is clear on its Impact Goals and how they will be tracked

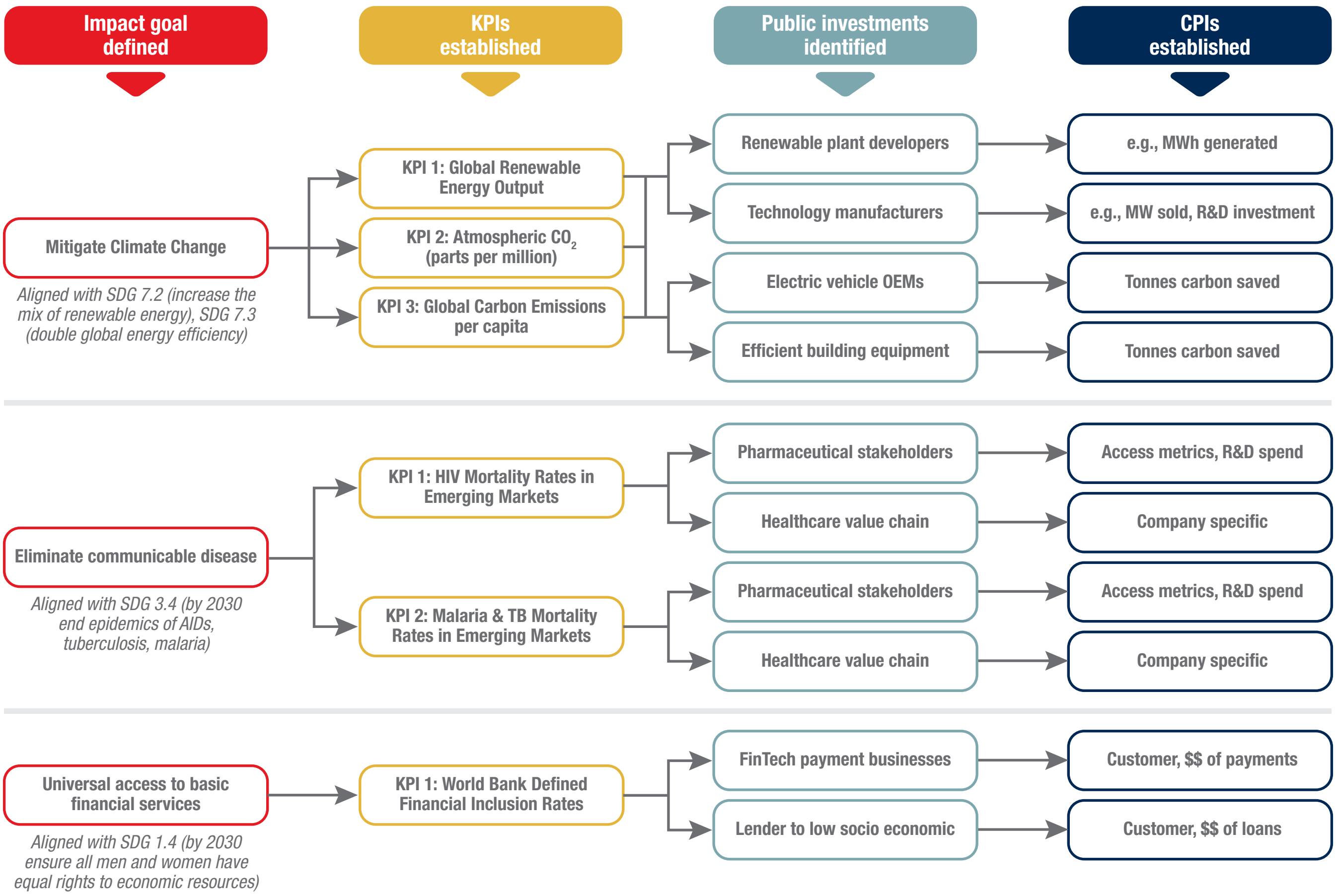
Nomura Asset Management has identified four areas of societal priority and against these, six desirable outcomes or "Impact Goals". While still delivering attractive investment results we are committed to work towards these goals through our portfolio holdings and engagement activity. Tracking and reporting progress is critical to the achievement of any goal, but especially where the goal is long term in nature and large scale. This is precisely the nature of the Impact Goals.

For each Impact Goal we have identified Key Performance Indicators (KPIs) to track progress. The KPIs are specific, numerically measurable proxies for the "Impact Goals" whereby positive movement in the KPIs indicates positive progress towards the relevant goal. Please see below figure.

	Environment		Society	
	Climate Change	Natural Capital	Access to Healthcare	Social Responsibility
ESG Statement (NOMURA)				
Impact Goals	**Mitigate Climate Change:** Keep global warming to below 2°c	**Mitigate Natural Capital Depletion**	**Eliminate Communicable Disease** **Mitigate the Obesity Epidemic**	**Global Access to Basic Financial Services** **Global Access to Clean Drinking Water**
Key Performance Indicators	Global Renewable Energy Output Atmospheric CO_2 Levels Global Carbon Emissions per Capita	Material Consumption per Capita Global Annual Tree Cover Loss	Deaths due to HIV, TB and Malaria Obesity related Death Rate	Percentage of population who are Unbanked Percentage of Global Population with Access to Safe Drinking Water
Alignment with the UN SDGs	**SDG 7.2** Increase the mix of renewable energy **SDG 7.3** Double global energy efficiency	**SDG 12.2** Achieve the sustainable management and efficient use of raw materials	**SDG 3.3** By 2030, end epidemics of AIDS, Tuberculosis and Malaria **SDG 3.4** Reduce mortality from non-communicable diseases	**SDG 1.4** By 2030, ensure all have equal rights to economic resources **SDG 6.2** Achieve universal access to clean water

We also monitor and track delivery by investee companies

As with the Impact Goals so with investee companies we must track and report on the contribution to the delivery of the Impact Goals. A clear line can be drawn from each KPI to specific investee companies that support its delivery and for each company we identify the Company Performance Indicators (CPIs) that will act as a proxy measure for the expected positive impact. Thus measurable connections between investee companies and Impact Goals are established and useful reference points for company engagement are created. The figure below illustrates the hierarchy of Impact Goals, measured by KPIs, positively impacted by investee companies, themselves measured by CPIs.



Real World Examples

As an example of the ever growing importance of responsible investing, NGOs are increasingly aware that investors can help address environmental and social issues. In March 2016, the Rainforest Action Network (RAN) hand delivered a report to every participant of an investor conference in New York City. A US clothing retailer was one of the companies presenting to investors at this conference, and RAN claimed that almost 300 of the products the aforementioned retailer sold contained fabrics derived from wood coming from the destruction of Indonesian rainforests. The company did not issue a rebuttal of this report, and we took the decision to follow up with the company to express our concerns and enquire as to whether the RAN findings were true. When the CFO subsequently visited our offices, we posed questions on any progress made so far, and we have continued to engage on an ongoing basis. The company has subsequently changed its sourcing practices and the Rainforest Action Network have publicly praised the company for bringing them into line with their recommendation. We continue to engage with the company to monitor its progress and ensure compliance with these standards.

Illustration of our Impact Investing approach in practice

Nomura Asset Management have adopted 'Eliminating Communicable Disease' as a Social Impact Goal in line with SDG Target 3.3. In order to measure global progression towards this goal and optimise our investment and engagement activity we monitor WHO defined global deaths from HIV, malaria and tuberculosis (TB). Deaths have been steadily declining however still today 800,000 people die every year from AIDS and TB death rates remain stubbornly high at over 1.2 million per year. The importance of access to medicine in the poorest countries where treatment is needed the most, alongside R&D of treatments and vaccines cannot be understated.

We learnt that through first clearly addressing the desirable SDG Outcomes we were able to broaden our perspective with regards to potential investments. For SDG 3.3 we were able to identify companies across the healthcare value chain playing vital roles – pharmaceuticals, medical equipment, testing specialists. We identified a leading company within HIV care that spends billions of dollars every year researching treatments and has been a pioneer in ensuring its drugs reach those most in need. The company was the first pharmaceutical partner of the medicines patent pool and today over 12 million people world-wide within low to middle income countries receive HIV treatment as a result of its access strategies. We track both the number of HIV patients being reached and R&D expense as Company Performance Indicators (CPIs) of how this company is impacting our social goal of eliminating communicable disease (specifically HIV).

Our engagement activity with the company is focussed around ensuring accurate communication of the impact the company is having and ensuring that access strategies are prioritised. We engage both directly and collaboratively to maximise the impact of our investment. The Access to Medicine Foundation has been an important avenue for bridging investor understanding on Access and supporting the collaborative engagement with companies to push for greater focus on ensuring Access. We have participated in and indeed coordinated a number of engagements with leading pharmaceutical companies engaging on expanding access strategies geographically and across drug portfolios.

Disclosures

This report was prepared by Nomura Asset Management U.K. Ltd. for information purposes only on the general environment of investment conditions.

Although this report is based upon sources we believe to be reliable, we do not guarantee its accuracy or completeness. Unless otherwise stated, all statements, figures, graphs and other information included in this report are as of the date of this report and are subject to change without notice. The contents of this report are not intended in any way to indicate or guarantee future investment results as the value of investments may go down as well as up. This report is not intended as a solicitation or recommendation with respect to the purchase or sale of any investment fund or product. Before purchasing any investment fund or product, you should read the related prospectus and/or documentation in order to form your own assessment and judgment and, to make an investment decision. To the extent permitted by law, NAM UK does not accept liability for any statement, opinion, information or matter (express or implied) arising out of, contained in or derived from, or any omission from this document, whether negligent or otherwise.

This report may not be reproduced, distributed or published by any recipient without the written permission of NAM UK.

NAM UK is authorised and regulated by the Financial Conduct Authority.

For further information please contact **info@nomura-asset.co.uk** or visit our website **www.nomura-asset.co.uk**

NOMURA

Nomura Asset Management U.K. Ltd.
1 Angel Lane
London
EC4R 3AB