Integrating ESG Analysis into Active Equity Investing
Executive Summary

• The equity research process at Amundi Pioneer encompasses a broad set of ESG-related risks that are deeply integrated into our fundamentally focused, active investment processes. We believe this approach is essential to identifying quality firms with sustainable business models that can produce competitive returns over time.

• With the confusion and explosion of competing third-party ESG research, assessing quality companies is not straightforward. Our view is that a sound fundamental approach requires a disciplined, holistic investment process that embraces the nuance and interplay between fundamentals, competing business models, profit, valuation and of course, risks. ESG is a subset of those risks.

• We believe that an experienced fundamental analyst team, combined with a disciplined, structured analytical process and our ability to identify mispriced business model durability, can create alpha for our investors. (Alpha measures risk-adjusted performance, representing excess return relative to the return of the benchmark. A positive alpha suggests risk-adjusted value added by the manager versus the index.)

• In our view, this level of integration is the ultimate test for an integrated approach to ESG.

• We believe this approach offers a significant competitive advantage that can assist investors to identify strategies that can help optimize return potential while being socially responsible.
The Path to ESG Investing

There is an inexorable wave of interest in responsible investing that goes far beyond the historically familiar approach of excluding certain “sin stocks” from investment portfolios. For many investors, allocators of capital, companies and government institutions, the strategies that inform responsible investment approaches, commonly referred to as ESG (Environmental, Social, and Governance), are becoming critically important to understand because of the rising influence ESG factors have on stock valuation. However, the topic is confusing and complex due to the rapid proliferation of third-party ESG ratings systems, terminology and approaches. In our view, distinguishing between the values that are emerging through ESG considerations and the valuations historically used to justify investment decisions may bring clarity to the discussion. It is through this lens of value versus valuation that we can better understand the role of ESG and distinguish its application across different responsible investment approaches.

There is little agreement as to what the application of ESG actually means in practice. Certainly, ESG factors are often centrally related to peoples’ values – a point that distinguishes them from other fundamental elements that have been relied upon in traditional securities analysis. For some investors, this introduces a new dimension to asset management. Rather than pursuing pure, economically driven performance objectives, investors now use ESG factors to pursue a socially beneficial outcome or impact that is not necessarily related to investment performance. While some investors may be willing to sacrifice potential investment returns to achieve a specific outcome, many continue to focus on investment objectives such as maximizing total return, generating income and/or preserving capital. For these investors, ESG is sometimes viewed purely as a risk-mitigation tool. However, we believe integrating ESG into an economically driven approach focused on a specified investment objective is more nuanced, and should not be defined so simply.

ESG Integration at Amundi Pioneer

Amundi Pioneer has incorporated sustainable investing practices into its investment process for decades. Our founder, Philip Carret, believed companies that pursued practices harmful to society offered little, if any, intrinsic value for shareholders. This approach endures at our firm today. However, the risk framework used by our investment team has evolved to encompass a broad set of ESG-related risks that are deeply integrated into our active investment processes. Our focus is on a fundamentally integrated, holistic ESG framework.

We seek to invest in companies we believe offer sustainable business models and strong competitive positions, at reasonable prices. We believe this approach can result in competitive performance over the long-term. The key to this approach is the ability to combine the identification of emerging and deteriorating trends in sustainability with a keen focus on valuation developed through in-depth fundamental analysis. In addition to specific ESG considerations, we have four primary investment constructs that are central to our investment process.

- Engage with company managements to evolve corporate strategy
- Recognize mispriced business model durability
- Identify quality at a reasonable price
- Apply ESG-specific exclusions
A Fundamentally Integrated, Multi-Dimensional ESG Framework

For Amundi Pioneer, a deep understanding of an investment case is the result of exhaustive proprietary research. This includes an assessment of a company’s business model and its durability, industry structure and competitive analysis, growth opportunities, cyclical or secular themes and, of course, valuation. We do not view ESG factors as separate and distinct from any of the other risks and factors enumerated above. They are a central component of our fundamental analysis.

We do not believe there is a “one-size-fits-all” ESG measure that can be used to evaluate the full universe of investment opportunities. Our view is that three elements comprise a truly robust fundamental research and investment process: Understanding, Integrating and Engaging.

Understanding: Our equity research analysts employ an economic value-added (EVA) framework to measure and value corporate profit. We do not distill the value of a company into a single number or set of numbers (e.g. EPS, EBITDA, P/E)\(^1\). While we use these statistics and many others to inform us, we use a more complex, holistic approach. For example, we try to capture the entirety of a company financial report by carefully reversing out accounting distortions, while applying capital charges, to come up with our own “clean” measure of profit and return on invested capital.

Integrating: Nothing in our investment process is untouched by ESG considerations. ESG integration is an implicit component of our investment process, incorporated into our financial forecasts and valuation assumptions. We believe that an experienced fundamental analyst team, combined with a disciplined, structured analytical process and our ability to identify mispriced business model durability, can create alpha for our investors. Our view is that a sound fundamental approach requires deep company and industry analysis of the nuances of each unique company business model, operating drivers, invested capital requirements, and of course, risks, of which ESG is a subset.

Our process requires embracing the interplay between competing business models, profit, valuation, ESG factors and investment decision-making. In our view, this level of integration is the ultimate test for an integrated approach to ESG.

Our parent company, Amundi, maintains significant resources to assess, analyze and integrate ESG factors from a myriad of third-party data providers and rating agencies, as well as internal ESG specialists. These extensive resources are utilized by Amundi Pioneer’s equity team to analyze and thoughtfully weed out enormous quantities of data to identify what we see as critical ESG drivers that have the potential to impact a company’s future value.

Engaging: One important way we evaluate the nuance of the data is to engage with company management to assess relevance to the industry, and across sectors and regions. We understand and use history to identify patterns of improvement or deterioration, incorporating the information into our broader, more comprehensive investment framework. In essence, like the EVA framework that is our organizing and integrating principle for financial data, we employ a holistic, multi-dimensional concept to ESG data.

\(^1\)Abbreviations for Earnings Per Share; Earnings Before Interest, Tax, Depreciation and Amortization; Price/Earnings ratio, respectively.
Emerging ESG Risks

Up until the most recent decade, information on environmental, social, and governance risk either did not exist or was dismissed as a critical determiner of investment value. To those of us focused on monitoring the investment landscape, ESG risks and their impact on valuations are growing in importance. In this age of “information explosion,” many of these risks are becoming malicious destroyers of value. For example:

<table>
<thead>
<tr>
<th>Factor</th>
<th>Example</th>
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<tbody>
<tr>
<td>E</td>
<td>Poor environmental practices; pollution that can be brand destroying</td>
</tr>
<tr>
<td>S</td>
<td>Damage from the social media impact of a poor corporate culture on brand identity, recruiting and customer relationships</td>
</tr>
<tr>
<td>G</td>
<td>Cybersecurity, including communication and response time in the event of customer data breaches</td>
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Essentially, ESG factors are data points or considerations that can provide valuable insights into a company’s environmental challenges, reputational and regulatory risk, and problems with governance, or misalignment of management incentives. The challenge for the industry is that there is no widely agreed upon framework for what ESG is, and how and when it should be reported. For example, should ESG data be updated monthly, quarterly or annually? How should investors respond to ratings changes? The lack of consistency leads to interpretations of the data that can vary widely. One rating service can give a company a high ESG rating while a different firm can give the same firm a poor rating.

Where measurable ESG information is lacking, we believe seeking alternative data sources and/or engaging with management becomes essential. For active equity managers focused on fundamental analysis, the ability to engage with management as part of the ESG analysis process presents a competitive advantage, because it is central to one’s value proposition. For example, a company with a poor ESG rating may pursue a strategy that will improve its rating, potentially resulting in an investment opportunity. In an efficient market, equity valuations usually reflect risks, but we seek to buy equities where the market is mispricing the sustainability of a risk-adjusted business model. We buy companies with risks, including ESG risks, but we expect those risks to be discounted into the stock price. ESG criteria is also considered as part of our sell discipline. Negative ESG momentum can result in a security being sold if the investment team determines that the additional risk is no longer worth the upside potential.
A Closer Look at ESG Equity Factors

We compartmentalize ESG into eight broad fundamental categories beyond the Environmental, Social and Governance pillars. Some categories are applicable to all companies, while others vary by industry:

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Natural Resources</th>
<th>Pollution &amp; Waste</th>
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<tr>
<td>• Carbon Emissions&lt;sup&gt;2&lt;/sup&gt;</td>
<td>• Water Stress&lt;sup&gt;2&lt;/sup&gt;</td>
<td>• Toxic Emissions and Waste&lt;sup&gt;2&lt;/sup&gt;</td>
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<tr>
<td>• Financing Environmental Impact</td>
<td>• Raw Material Sourcing</td>
<td>• Electronic Waste</td>
</tr>
<tr>
<td>• Product Carbon Footprint</td>
<td>• Biodiversity and Land Use</td>
<td>• Packaging Material and Waste</td>
</tr>
<tr>
<td>• Climate Change Vulnerability</td>
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<tr>
<th>Social</th>
<th>Product Liability</th>
<th>Stakeholder Opposition</th>
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</thead>
<tbody>
<tr>
<td>• Labor Management&lt;sup&gt;2&lt;/sup&gt;</td>
<td>• Product Safety and Quality</td>
<td>Controversial Sourcing</td>
</tr>
<tr>
<td>• Human Capital Development</td>
<td>• Privacy and Data Security</td>
<td></td>
</tr>
<tr>
<td>• Health and Safety&lt;sup&gt;2&lt;/sup&gt;</td>
<td>• Chemical Safety</td>
<td></td>
</tr>
<tr>
<td>• Supply Chain Labor Standards</td>
<td>• Responsible Investment</td>
<td></td>
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<tr>
<td></td>
<td>• Financial Product Safety</td>
<td></td>
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<tr>
<td></td>
<td>• Health Risks</td>
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<tr>
<th>Governance</th>
<th>Corporate Behavior</th>
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<tr>
<td>• Board&lt;sup&gt;2&lt;/sup&gt;</td>
<td>• Business Ethics&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>• Ownership Structure&lt;sup&gt;2&lt;/sup&gt;</td>
<td>• Anti-Competitive Practices&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td>• Management Compensation&lt;sup&gt;2&lt;/sup&gt;</td>
<td>• Tax Transparency</td>
</tr>
<tr>
<td>• Accounting&lt;sup&gt;2&lt;/sup&gt;</td>
<td>• Corruption and Instability</td>
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<sup>2</sup>Factors assessed for all companies. Others are as appropriate.

In the Environment pillar, how a company deals with emissions, waste, its carbon footprint, raw material sourcing and other environmental issues are all critical factors in our assessment of its valuation, future financial outlook, competitive positioning and business model durability.

Governance considerations are important to assess how well a company is managed, the independence and structure of the board of directors, and the alignment of management compensation with the interests of shareholders. This factor can highlight the vulnerability of an otherwise good business to bad corporate governance.

Similarly, in the Social pillar, treatment of employees, customers and communities are all critical to business model durability, future financial results and valuation. Below is an example of how we think about a few of the key Social risks.
Case Studies – ESG’s Role in a Holistic, Risk-Adjusted Valuation Framework

We believe it would be impossible to comprehensively analyze a company without including ESG factors. At the same time, focusing only on ESG factors to derive an investment decision is equally problematic. This is because the controversies are not always clear or universally agreed upon, and because valuation is a critical component of an investment decision. In many cases, ESG factors and other fundamental data are inextricably linked and interdependent, but in some cases they are diametrically opposed! The challenge to separate them into neat subsets is illustrated by Case Study 1, below.

Case Study 1: A Balancing Act Between Two Retailers

<table>
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<tr>
<th>Retailer A</th>
<th>Retailer B</th>
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<tbody>
<tr>
<td>Pays an above-market, “living” wage</td>
<td>Pays minimum wage</td>
</tr>
<tr>
<td>Offers benefits</td>
<td>Provides no benefits</td>
</tr>
</tbody>
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One could conclude that Retailer A will have happier employees, lower turnover, a better customer experience and perhaps lower reputational or regulatory risks (e.g., minimum wage increases, minimum health coverage mandates). Does this suggest that the appropriate ESG-based investment should only be in the retailer with higher paid employees? Not at all. Perhaps the minimum-wage employer serves a social good in their communities, has generated strong profits and operates a sustainable business model.

We employ a risk-adjusted valuation framework that assesses the relative importance of numerous Social factors relative to all other fundamental operating drivers. For example, we would compare the impact on each firm of a bear-case scenario that incorporates a minimum wage increase or government-imposed health care mandate that hits operating margins. Alternatively, we could determine the relative speed, cost and efficacy of each retailer’s initiatives to attract and retain employees, juxtaposed against the relative importance of customer service metrics to sustainable growth and profit generation.

As fundamental investors, we believe that in order to properly assess an investment, a lens to link ESG risks to valuation is required. The key point is that ESG risks are nuanced and company-specific.

Example provided for illustrative purposes. Not meant to represent a recommendation to buy or sell any security.

At Amundi Pioneer, we do not make any buy and sell decisions without a full financial forecast and valuation. We develop models to value the durability of a business model and assess the potential impact of changes in key variables. Measuring and valuing the impact of ESG considerations and, as importantly, considering potential adjustments to ESG factors, are part of this discipline. For every company we own, or consider owning, we model a full range of fundamental and valuation outcomes (i.e., base case, bull case, and bear case) to avoid the behavioral analysis flaw of pinpoint precision. The impact of ESG considerations is as important a factor as any when considering forecasted sales growth, operating margins and capital intensity, plus the appropriate cost of capital and terminal multiple. These can show up in the base case, bull case or bear case, depending on the consideration.

Case Study 2 (next page) demonstrates this point.
Case Study 2: Increasing Privacy Concerns in Social Media

We value the potential controversy and weigh it against the company’s ability to execute its business model, despite the current privacy concerns. We then generate an appropriate market value.

The bear case incorporates a scenario in which privacy issues hurt the sustainability of the business model and the amount investors will pay for it.

- Revenue assumptions: We would continue to forecast digital ad spending growth to outpace global ad spend, and assume the privacy concerns cause the company’s share of digital ad spending to stagnate over the five-year forecast period.
- Embedded in our assumption is the “utility” that users of this social media platform found in the 2015-2019 version of “social media” is not additive to their lives going forward. People will still connect and on occasion share via the Internet, but the wholesale “living a social media life” will no longer be the default mode for as many users.
- The consumer backlash against social media could ultimately make the established platforms less enticing to advertisers as consumer “engagement” with these platforms declines.
- We are already seeing evidence of a decline in time spent on platforms and number of active monthly users (although the ability to correctly assess true “active users” can be questioned).
- The terminal valuation assumption (future value), which is central to our assessment of a valuation, suggests that a few years of waning relevance and declining ROI for advertisers, as well as the possibility of incrementally negative regulatory outcomes, will hurt the social media industry.

Thus, in the bear case scenario example, we could possibly assume no growth in profit beyond the five-year out terminal year.

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Our fundamental ESG construct can work the other way when we find ESG factors that introduce second derivative impacts that create investment opportunities. In Case Study 3 (next page), a metal beverage can manufacturer benefits from an improved business model, as it develops alternatives to plastic bottles, which are causing environmental damage.
**Case Study 3: A Metal Can Manufacturer Benefitting from Consumer Backlash against Plastics**

It might not seem obvious that a metal can company is an ESG beneficiary. Cans are a boring business and, in general, packaged beverages and foods are not a growth business. However, that is not what we observed.

In the initial investment case analysis, our bull case scenario had embedded a higher sustainable revenue growth as a result of a secular transition from plastic bottle packaging to metal for beverages.

- Plastic has been the bottle of choice for years due to its low production costs and light weight (cheaper to transport).
- We observed that a plastic policy change in China could be a tipping point for plastic relative to cans as China stopped accepting US plastic recyclables in 2018, which had implications across many industries.
- Long-term pressure on plastic bottle volumes could gain some share back for cans as companies reassess their ESG policies and consumer reputations.
- Initially, we thought that this share gain would not be visible until 2020 at the earliest as 1) consumer soft drink companies made much better margin on sales in plastic bottles than they did in cans, and 2) consumers would need time to get used to the idea of buying beverages in “opaque” packaging again.
- This was potentially meaningful to revenue and terminal valuation assumptions as extra revenue growth for a GDP-level growth business is meaningful to our forecast and what investors will pay for incremental long-term growth, which is why it was a bull case.
- As we moved ahead into early 2019, however, we started to observe that the transition was accelerating. 60% of all new beverage product launches in the US in 2018 had cans as their packaging choice over plastic and other substrates. This is up from 30% in recent years. Beverage company customers are trying to anticipate consumers’ change in preferences and base their decisions on sustainability over economics, appearance and convenience.
- While this will be a slow process, the potential opportunity is enormous. Even a small change can significantly boost production volume.

Thus, our bull case subsequently became our base case.

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**Conclusion**

The equity research process at Amundi Pioneer encompasses a broad set of ESG-related risks that are deeply integrated into our fundamentally focused, active investment processes. We believe this approach is essential to identifying quality firms with sustainable business models, and can provide competitive performance over time. With the confusion and explosion of competing third-party ESG research, assessing quality companies is not straightforward. We believe it is imperative to use a disciplined, holistic investment process that embraces the nuance and interplay between fundamentals, business models, profit, valuation and of course, investment decision-making. We believe this approach offers a significant competitive advantage that can help investors identify strategies to pursue optimized return potential, while being socially responsible.
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