HARDING LOEVNER

PERSPECTIVES: OUR VIEW ON ESG

Excerpted from the International Equity Third Quarter 2020 Report

We believe that companies that disregard the environmental and societal consequences of their operations or operate with weak corporate oversight put their long-term financial results at risk. While markets are still in the early innings of how they reflect such risks in prices, we have recently seen improvements in governance (notably, enhanced corporate practices in Japan and in certain emerging markets), and increased attention paid to social concerns such as supply chain conduct and issues related to data privacy and security. Another towering worry, of course, is the consequences of climate change along with the risks attendant to efforts to transition to cleaner energy sources. These are examples of risks that frequently get lumped together under the rubric of Environment, Social, and Governance (ESG) issues. Our analysts and portfolio managers pay close attention to these risks because they can contribute profoundly to the success or failure of our investments. We do not pursue social or environmental goals for their own sake; we see our fiduciary duty as requiring us to pursue the best risk-adjusted returns in the absence of client direction to the contrary.

BOTTOM-UP AND FULLY INTEGRATED

Unlike some other firms that have separate ESG units, we've concluded that the proper setting in which to assess ESG risks is within the overall fundamental analysis that we perform on each company under investment consideration. We believe that accurate assessment of these risks and opportunities requires a deep understanding of both the competitive landscape and industry structure. For instance, among our holdings, industrial gas manufacturers **Linde** and **Air Liquide** produce some of the highest CO2 emissions. Not only do they emit carbon in production of some of their gases, they are also enormous consumers of energy. However, on both fronts, this also positions them as potential catalysts and beneficiaries of change. The scale of these companies is such that they are now receiving steep volume discounts on renewable energy that are accelerating their transition to such power sources. Additionally, as renewable energy costs come down and electrolysis technology improves, both companies are well positioned for the eventual shift to fossil-fuel-free hydrogen production likely to occur over the next five to ten years—creating enormous opportunities in production, storage, and generally meeting the demands of a transitioning transportation sector.

In 2016 we incorporated a proprietary scorecard to evaluate companies' ESG risks systematically. The scorecard assesses companies across three dozen criteria, which include factors such as impact from environmental regulations, water consumption that could face scarcity costs, human capital management, and sourcing. Analysts use their factor assessments when setting assumptions in their company financial models. In addition, the total score for each company is incorporated into how we project its cashflows. A low score, for instance, degrades expected future cash flows and, all else being equal, will reduce the amount we are willing to pay for a business. The scores also provide an additional yardstick for portfolio managers and analysts to compare companies' ESG-related risks across industries and geographies, and to frame their debate around the analysts' risk assessments.

MORE THAN ACTIVIST

Proxy voting and company engagement, also responsibilities of the covering analyst, are other ways that we attempt to manage and mitigate ESG risks. We engage with companies to better understand their growth potential and risks to their profitability, and have never been shy in expressing our disagreement over actions that we think are not in shareholders' interests. We understand that it takes time, sometimes years, to effect change in our desired direction. This has been the case with corporate governance reforms at some of our Japanese holdings, such as at **Fanuc**, where we have taken management to task for its excessive cash hoarding. If we determine that an unresolved ESG issue represents an unacceptably high investment risk, our usual course of action is disinvestment rather than continued engagement.

ULTIMATELY, AGAINST THE GRAIN

We are leery of, and therefore do not rely on, the ESG assessments of ratings services, although we do encourage our analysts to understand them. Our analysts, in completing their own assessments, have often found inconsistent, incorrect, or even non-existent analysis underpinning such third-party assessments.

Favorable carbon and other ESG scores are attractive to investors with explicit ESG mandates. For the most part, our portfolios tend to score favorably on external ESG metrics and typically have moderate-to-low carbon intensity, despite the fact we do not impose a carbon emissions ceiling on our portfolio holdings. If flows into ESG-explicit products continue to grow, they may lead to a widening valuation premium for companies with appealing ESG profiles. But higher valuations not associated with sustained superior profitability lead to lower long-term returns. Simultaneously, companies that are out of favor due to their perceived ESG risks may become undervalued and offer correspondingly higher returns. We fully expect this disparity to create opportunities for fundamental investors capable of assessing the risks independently. Our analysts' ability to measure and evaluate ESG risks autonomously, in conjunction with their deep industry knowledge, should increase our capacity to benefit from the resulting opportunities.

Opinions expressed are those of Harding Loevner and are not intended to be forecasts of future events, a guarantee of future results, nor investment advice. Past performance is not a guarantee of future results. There is no guarantee that any investment strategy will meet its objective. The information provided should not be considered a recommendation to purchase or sell a particular security. It should not be assumed that investment in the securities identified has been or will be profitable.

400 CROSSING BLVD, FOURTH FLOOR • BRIDGEWATER, NJ 08807
T (908)218-7900 • F (908)218-1915 • HARDINGLOEVNER.COM

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