ESG RESEARCH INTEGRATION LESSONS FROM GLENCORE AND STEINHOFF

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ABOUT THE AUTHOR

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KEY TAKEOUTS

- OUR JOB AS FUND MANAGERS IS NOT TO AVOID RISK ALTOGETHER BUT TO BALANCE RISK APPROPRIATELY WITH POTENTIAL REWARD.
- ESG RESEARCH CASTS A SPOTLIGHT ON UNQUANTIFIABLE RISKS THAT NEED TO BE CONSIDERED WHEN CONSTRUCTING PORTFOLIOS.

Glencore was a significant holding across our funds at the start of 2019, yet over the course of the year we sold the stock to zero. It's not a coincidence that 2019 was also a year in which the investment team drove a step change in how we integrate Environmental, Social and Governance (ESG) research into our investment process. By outlining how we came to our decision on Glencore, I will illustrate how integrating ESG research has enhanced the way we value companies and debate risk.

WHY DID WE BUY GLENCORE?

There are two aspects to our investment process. Firstly, we carry out detailed fundamental bottom-up research. We dedicate a significant amount of time and effort to analyse a company, examining in great depth the business model, the company's key drivers, its future growth prospects, its competitors, its profitability and balance sheet health. The purpose of this work is to determine an estimate of the long-term "intrinsic value" of the business. Our process is based on the philosophy of investing in businesses that trade at a discount to our estimation of "intrinsic value".

However, as Winston Churchill once said, "The future is unknowable, but the past should give us hope." We acknowledge that there are limitations and biases inherent in our estimates of intrinsic value. Therefore we supplement our bottom-up research with a second aspect that seeks to independently, and in our case quantitatively, "confirm" our fundamental assumptions. The "confirmation" factors assess and score the quality of the company up to that point, its historical and prospective growth and market sentiment towards the share. This ensures that each share is scored and ranked quantitatively by its past independently of analyst input.

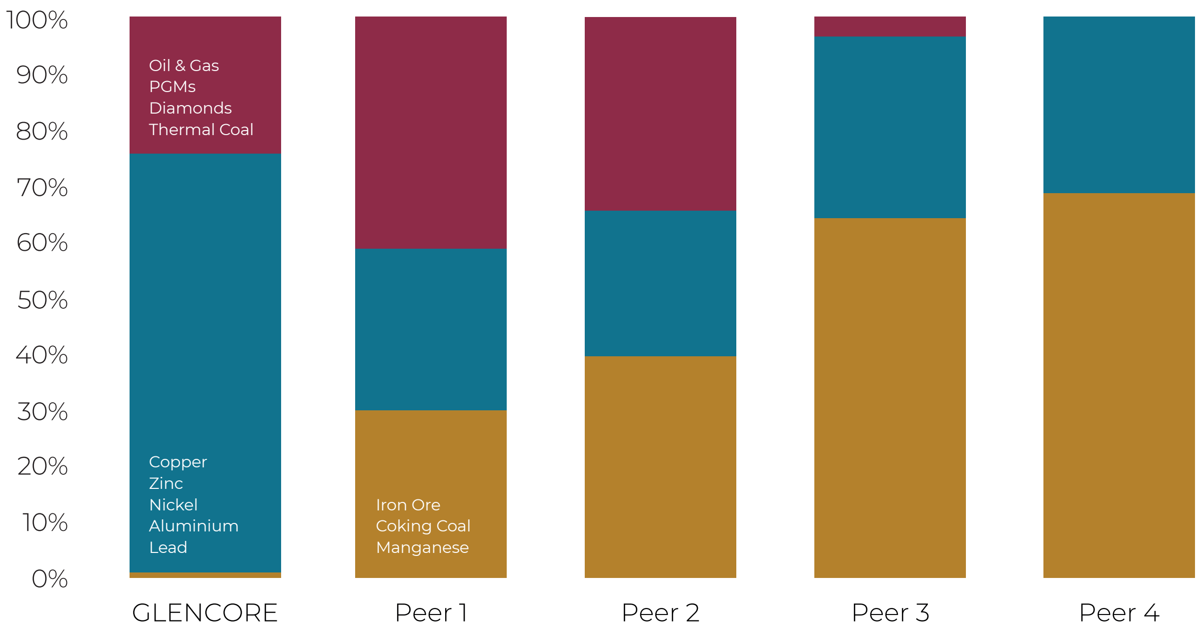
Diversified portfolios are carefully constructed by selecting shares that rank best on both valuation and confirmation factors, while managing overall portfolio volatility. Where valuation meets confirmation, we find our highest conviction ideas.

Our initial investment in Glencore was in 2014. Our fundamental research concluded that Glencore offered significant value relative to the price it was trading at. Glencore is different from the other mining houses listed on the JSE. It has no exposure to iron ore, which in 2014 had risen to levels beyond our estimates of what was sustainable and presented risk of capital loss in investing in other miners.

Glencore has a commodities trading business referred to as the Marketing division – an opaque but a stable and profitable business. Due to the Marketing division's business model, Glencore relies on higher leverage than traditional mining houses. This is a point often misunderstood by the market, which created a further buying opportunity in 2015 when balance sheet fears created panic and overly pessimistic expectations. We continued to invest client funds into Glencore as the price fell to lows of R19 in 2015, and subsequently earned great returns for clients as the price rose to peaks of R68 in 2018. Throughout these years, our quantitatively driven confirmation factors ranked Glencore as a potentially high return investment.

WHAT WAS DIFFERENT THIS TIME?

Glencore had made headlines for crossing the line before. The company was born out of the private holding company of Holocaust refugee turned billionaire Marc Rich, who pioneered the disruption of the spot oil market by displacing the in-house traders of big oil producers in the 1970s. Rich's infamous legacy includes making the FBI's most wanted list. He left the US in the 1980s for Switzerland to avoid charges of tax fraud and trading with



Sources: Glencore investor presentation; UBS estimates of contribution to 2018 EBITDA forecast

sanctioned nations. In 2017, Glencore's dealings in the DRC with Dan Gertler, a controversial Israeli mining magnate, came under scrutiny. Earlier in 2018, the United States Department of Justice announced an investigation into money laundering and corruption focused on Nigeria, the DRC and Venezuela. The Katanga restatement was signalled the year before. So why was this headline troubling?

STEINHOFF CHANGED THE LANDSCAPE FOR DEALING WITH ESG RISKS

The post-Steinhoff era has been characterised by an elevated level of focus on ESG issues from clients and fund managers alike. Over the course of 2018, the investment team wrestled with this critical question: How did our process miss the Steinhoff risks?

When we invested in Steinhoff, the investment case was aligned with our philosophy and we had followed our process. Our detailed, bottom-up fundamental research concluded that Steinhoff was undervalued and supported a buy. Our conviction in our valuation was supported by our quantitative "confirmation" factors. We saw catalysts on the horizon to unlock that value. Yet our exposure had cost clients in 2017. Even as rumours of accounting irregularities emerged in the German press, we held a position believing that the discount to our valuation was compelling enough to compensate for the governance risks. That belief was proven incorrect. Were we making a similar mistake with Glencore in assuming the potential rewards justified the potential risks? The key lesson from Steinhoff was that there are times when the biggest risks cannot be adequately quantified.

INTEGRATING ESG RESEARCH INTO THE GLENCORE INVESTMENT CASE

As an investment team we have grappled with integration of ESG issues in our investment and ownership process since 2012. We have built a credible process around proxy voting and engagement on key ESG matters. By contrast, consistently embedding ESG research into our investment process has proven more difficult. It was once not uncommon for ESG issues, particularly unquantifiable ones, to be treated as a "margin of safety" consideration with more quantifiable valuation work being the primary focus. In 2019, we ratcheted up our ESG integration efforts by revisiting the investment cases of our key holdings while paying specific attention to ESG issues. Glencore was one of the holdings reviewed and several issues were highlighted. I will expand on two of significance: the structural headwinds facing coal and the accounting risk inherent in the Marketing division.

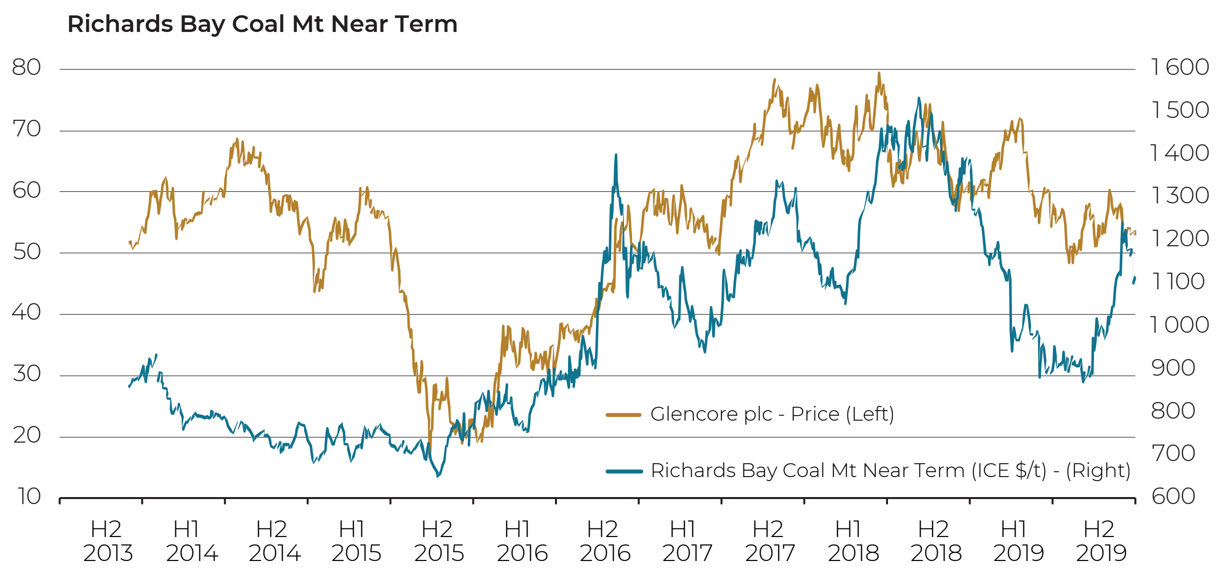
COAL SUBSTITUTION – AN ENVIRONMENTAL ISSUE AFFECTING GLENCORE'S FUTURE CASH FLOW

Coal is a substantial part of Glencore's commodity mix, and the share price often weakens in tandem with coal price weakness. Our ESG analysis emphasised the risk of the uncertainty of coal's future as a source of energy. As more natural gas fields have been exploited, the price of gas has fallen. Natural gas is a less carbon-intensive source of energy relative to coal. As gas has become cheaper, many countries have pivoted away from thermal coal towards natural gas to meet their energy needs with a smaller carbon footprint. This shift has created a structural ceiling on coal prices. While miners often make up for lower prices with increased volume, Glencore cannot employ that strategy in this case. Climate Action 100+, an investor initiative that ensures the world's largest corporate greenhouse gas emitters take necessary action on climate change, includes Glencore on its list as contributing the most. In response to pressure from the activist investor group, Glencore committed to capping its coal production at 2019 levels, thereby limiting further volume growth. This environmental issue is having a tangible impact on future cash flows.

GLENCORE'S MARKETING DIVISION FLAGGED FOR RISK OF ACCOUNTING IRREGULARITIES

Glencore's Marketing division accounts for 15% to 30% of the group's EBITDA depending on the profitability of the mining operations. The Marketing

GLENCORE'S SHARE PRICE IS INFLUENCED BY THE COAL PRICE



Source: Factset

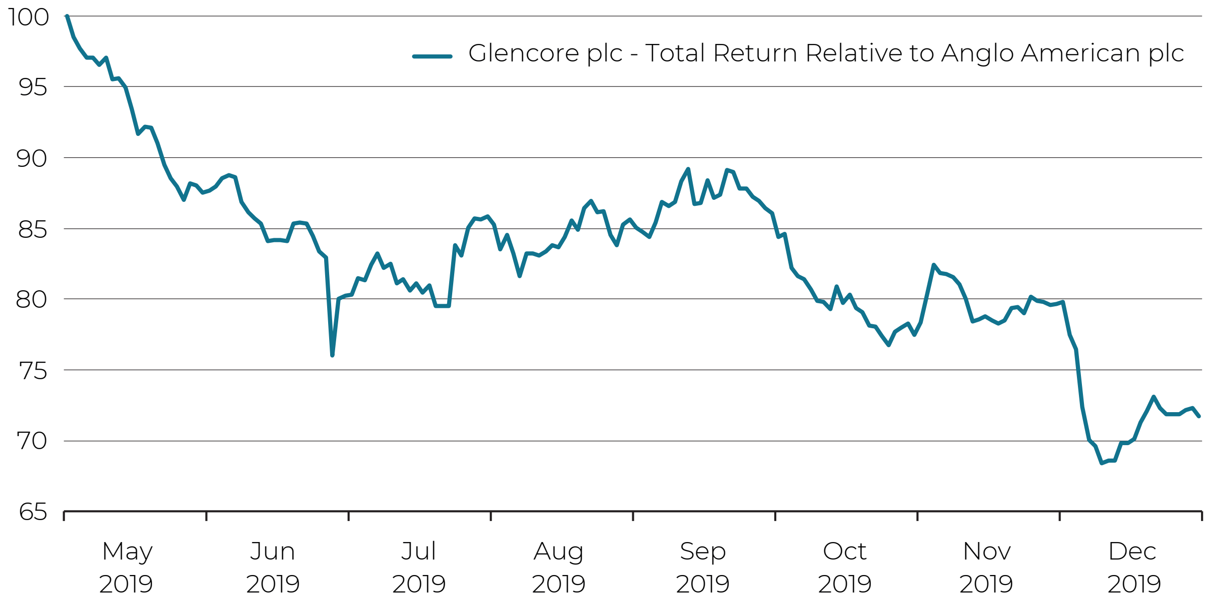
division was expanded around the commodities trading business that Marc Rich established in the 1970s. Ivan Glasenberg, company CEO and owner of 9% of listed shares, rose through the ranks in Marketing, as did many of the senior executives. Marketing's business model is to broker sales between commodity producers and customers globally and manage the logistics involved. Revenue is derived from high volumes of transactions across more than 90 commodities, derivatives are widely used and discretion is required to determine when a sale has taken place under long-term contracts held with customers. The nature of these contracts means that the accounting is complex and opaque. Revenue recognition has been flagged as a key audit risk by the auditors over a number of years.

SELLING GLENCORE – NOT EVERYTHING THAT COUNTS CAN BE COUNTED

We took the decision to switch our Glencore shares into Anglo American, which at the time offered value – though less so than Glencore – with significantly lower risk. We arrived at this decision after weighing up the valuation work, the confirming quality, growth and sentiment factors, the coal price scenarios and the growing list of governance concerns.

Our job as fund managers is not to avoid risk altogether but to balance risk appropriately with potential reward. A coal price in a peak coal world? This can be estimated to inform a judgement call. But when it comes to valuation, how cheap is cheap enough to compensate for poor governance and the risk of accounting irregularities? As

Glencore plc



the common quote says, “Not everything that can be counted counts. Not everything that counts can be counted.”

INTEGRATING ESG RESEARCH WILL ENHANCE OUR ABILITY TO DELIVER SUPERIOR RISK-ADJUSTED RETURNS

The goal with integrating ESG research into the investment process is to reach a point where there is no longer “ESG research” and “bottom-up research”, but just research. The encouraging shift is the extent to which ESG issues have been elevated in investment debates. They are blending into conversations with company management alongside topics like competitor activity and managing working capital. Addressing ESG issues has the potential to become a box-ticking exercise, but we believe that integrating ESG authentically has the power to enhance our process.

Starting with bottom-up analysis, considering the cash flow impacts of ESG issues has sharpened our ability to forecast cash flows, assess companies' ability to service debt and to pay dividends. ESG research has expanded our vision range in spotting unrealistic market expectations implied in share prices. As with valuation work, ESG research is forward-looking and subjective in nature, hence we believe in confirming our fundamental research by evaluating stocks on quantitative quality, growth and sentiment factors based on historic data.

Most importantly, ESG research has cast a spotlight on unquantifiable risks that need to be considered when constructing portfolios. We select shares that rank best on both valuation and confirmation factors while managing overall portfolio volatility. Where valuation meets confirmation, we find our highest conviction ideas. However, neither our valuation nor our confirmation factors can always “count everything that counts”. Therefore, integrating ESG research will enhance our ability to deliver superior risk-adjusted investment performance to clients.