FIRST QUARTER 2021 FINDING VALUE IN ESG

Which has a stronger relationship to investment performance: static ESG scores, or ESG score improvement? We offer our observations, along with an integrated approach to engagement that can help value investors capitalize on ESG controversy.

One of the most intense areas of interest in the investment world today is how practitioners are integrating the consideration of environmental, social, and governance (ESG) issues into their investment process. Some managers have taken a quantitative approach, incorporating an evolving set of tools to invest in companies with high ESG scores. While others, Pzena included, have focused on the integration of ESG issues into the investment process and working with companies, as active owners, to address those issues.

An integrated approach appreciates the contribution ESG data providers have made to improving the availability and quality of data in the marketplace, but does not use overall ESG scores to make investment decisions. From our perspective, an ESG score is simply one of many inputs to our investment process and by no means the arbiter of investment decisions. That is something that will always be the purview of our bottom-up, fundamentally-driven research team.

Nevertheless, we are committed to furthering our understanding of the utility of ESG scores, particularly as it relates to positions or issues that clients have challenged us on. We therefore embarked on an intellectual exercise, making use of MSCI's ESG ratings, to examine three questions. The findings, while interesting, should be considered directional at best, given the limitations of this analysis[1].

1. Are stocks with lower ESG scores cheaper?

While there is no conclusive evidence, in general, lower ESG-rated stocks appear slightly cheaper than the overall universe.

2. Is there a relationship between ESG scores and investment performance?

Contrary to popular opinion, we found a weak relationship here. While cheaper companies may have lower ESG scores, this does not necessarily mean performance suffers.

3. Is there a relationship between ESG score improvement and investment performance?

This was where we saw the significantly stronger relationship (Figure 1). This implies that ESG improvement may be more important than a high ESG score per se. If true, weak ESG scores themselves would not automatically be a bad thing. In theory, investing in stocks with room for improvement is a win-win because stakeholders and society are better served when a company improves its ESG prudence, while shareholders are best served when the company mitigates its risks and provides strong shareholder returns in the process. If discarded by investors, a company may be starved of capital and therefore struggle to improve ESG credentials.

The benefit of sticking with a company through the tough times where we see the potential for turnaround and ongoing engagement is familiar to us as an ESG-integrated value investor.

[1] Limited timeframe of data (January 2014- July 2020) which was also one of the worst periods on record for growth vs. value divergence; ESG ratings are still evolving in terms of depth and sophistication and there is still a lack of consistency among different ESG score providers; and, finally, as with anything, correlation does not necessarily imply causation.

The palm oil industry is notoriously controversial, garnering negative media attention for its inherent environmental and social risks. However, when done right, palm oil is a leader in supporting food affordability. Our investment in Wilmar, a leading Asian agribusiness, was made after accounting for these risks, and with the conviction that the company is run with franchise longevity in mind. As such, it is our belief that management has a vested interest in proactively addressing these business risks.

We identified several ESG risks for Wilmar as part of our investment research, specifically: deforestation for palm plantations, allegations of child labor and human rights in the supply chain and the complexity of supplier management. We have engaged extensively with the senior management and the Chief Sustainability Officer to: fully understand the associated investment risks; highlight the gravity of these issues; and emphasize the importance of proactive management.

In our view, Wilmar has been making steady progress and this has only accelerated over the last 5 years. For example, Wilmar has had a zero-tolerance 'no deforestation, no peat, no exploitation' policy in place since 2013, and recently enhanced its supply chain compliance and monitoring. This culminated in an immediate de-listing of suppliers with suspected transgressions, as well as education programs to help a supplier re-gain its standing. Being the first major player to make this commitment positioned Wilmar favorably among buyers, leading to improved volume, pricing, and strengthened competitive advantage. This also helped to draw a line under a reputationally damaging report from Amnesty International in 2016 that alleged widespread occurrence of exploitative labor practices.

The timeframe of these improvements broadly mirrors the performance period we examined (2015 to 2018) where Wilmar experienced a 41% 3-year return and was simultaneously upgraded by MSCI from a BB to BBB rated stock. While we cannot claim that all performance gains can be attributed to ESG improvement, at a minimum, good ESG is better for business at Wilmar.

While directional only, these findings are encouraging in that they start to challenge the commonly held perception that a value investment approach and ESG prudence are in conflict. It points to something we have always believed: value investors capitalize on valuation dislocations while working with companies to help improve E, S, and G issues. This is, of course, predicated on the importance of a strong research process to figure out which companies have real improvement potential.

The combination of deep research and engagement can help value investors capitalize on ESG controversy within the singular goal of generating superior returns.

Figure 1: Stronger Relationship Between Improving ESG Scores and Performance

PERFORMANCE BY IAS[1] ESG SCORE IMPROVEMENT QUINTILES
5TH QUINTILE IS LOWEST ESG IMPROVEMENT
JANUARY 1, 2014 - JULY 1, 2020

Global[2] Universe

IAS ESG Improvement Quintiles[4]	Average IAS Improvement Amount	Average 3YR USD Return[5]
1 (best improvement quintile)	2.27	28.9%
2	1.03	26.7%
3	0.33	24.1%
4	-0.28	23.0%
5 (lowest improvement quintile)	-1.51	18.6%
Overall Global Universe	**0.35**	**24.2%**

US[3] Universe

IAS ESG Improvement Quintiles[4]	Average IAS Improvement Amount	Average 3YR USD Return[5]
1 (best improvement quintile)	2.31	37.3%
2	1.06	33.9%
3	0.35	30.6%
4	-0.28	30.6%
5 (lowest improvement quintile)	-1.42	27.8%
Overall US Universe	**0.38**	**32.0%**

[1]Based on MSCI's Industry Adjusted Scores (IAS).
[2]The largest 2000 names globally ranked by market cap.
[3]The largest 1000 names listed in the US ranked by market cap.
[4]Analysis was performed using sector-neutral quintiles – i.e., we divided companies in each GICS sector into 5 equal quintiles to ensure proportionate sectoral representation in each IAS improvement quintile.
[5]Cumulative total shareholder return in US dollars.

Data tables display 3-year quarterly averages (15 data sets each table). Source: Capital IQ, MSCI, Pzena analysis. Past performance is not indicative of future returns.

FURTHER INFORMATION

These materials are intended solely for informational purposes. The views expressed reflect the current views of Pzena Investment Management ("PIM") as of the date hereof and are subject to change. PIM is a registered investment adviser registered with the United States Securities and Exchange Commission. PIM does not undertake to advise you of any changes in the views expressed herein. There is no guarantee that any projection, forecast, or opinion in this material will be realized. Past performance is not indicative of future results. All investments involve risk, including risk of total loss.

This document does not constitute a current or past recommendation, an offer, or solicitation of an offer to purchase any securities or provide investment advisory services and should not be construed as such. The information contained herein is general in nature and does not constitute legal, tax, or investment advice. PIM does not make any warranty, express or implied, as to the information's accuracy or completeness. Prospective investors are encouraged to consult their own professional advisers as to the implications of making an investment in any securities or investment advisory services.

The specific portfolio securities discussed in this presentation are included for illustrative purposes only and were selected based on their ability to help you better understand our investment process. They were selected from securities in one or more of our strategies and were not selected based on performance. They do not represent all of the securities purchased or sold for our client accounts during any particular period, and it should not be assumed that investments in such securities were or will be profitable. PIM is a discretionary investment manager and does not make "recommendations" to buy or sell any securities. There is no assurance that any securities discussed herein remain in our portfolios at the time you receive this presentation or that securities sold have not been repurchased.

Wilmar International Ltd. was held in our Emerging Markets Focused Value, Global Focused Value, Global Value, International Focused Value, and International Value strategies during the first quarter of 2021.

For U.K. Investors Only:

This financial promotion is issued by Pzena Investment Management, Ltd. ("PIM UK"). PIM UK is a limited company registered in England and Wales with registered number 09380422, and its registered office is at 34-37 Liverpool Street, London EC2M 7PP, United Kingdom. PIM UK is an appointed representative of Mirabella Advisers LLP, which is authorised and regulated by the Financial Conduct Authority. The Pzena documents are only made available to professional clients and eligible counterparties as defined by the FCA. Past performance is not indicative of future results. The value of your investment may go down as well as up, and you may not receive upon redemption the full amount of your original investment. The views and statements contained herein are those of Pzena Investment Management and are based on internal research.

For Australia and New Zealand Investors Only:

This document has been prepared and issued by Pzena Investment Management, LLC (ARBN 108 743 415), a limited liability company ("Pzena"). Pzena is regulated by the Securities and Exchange Commission (SEC) under U.S. laws, which differ from Australian laws. Pzena is exempt from the requirement to hold an Australian financial services license in Australia in accordance with ASIC Corporations (Repeal and Transitional) Instrument 2016/396. Pzena offers financial services in Australia to 'wholesale clients' only pursuant to that exemption. This document is not intended to be distributed or passed on, directly or indirectly, to any other class of persons in Australia.

In New Zealand, any offer is limited to 'wholesale investors' within the meaning of clause 3(2) of Schedule 1 of the Financial Markets Conduct Act 2013 ('FMCA'). This document is not to be treated as an offer, and is not capable of acceptance by, any person in New Zealand who is not a Wholesale Investor.

For Jersey Investors Only:

Consent under the Control of Borrowing (Jersey) Order 1958 (the "COBO" Order) has not been obtained for the circulation of this document. Accordingly, the offer that is the subject of this document may only be made in Jersey where the offer is valid in the United Kingdom or Guernsey and is circulated in Jersey only to persons similar to those to whom, and in a manner similar to that in which, it is for the time being circulated in the United Kingdom, or Guernsey, as the case may be. The directors may, but are not obliged to, apply for such consent in the future. The services and/or products discussed herein are only suitable for sophisticated investors who understand the risks involved. Neither Pzena Investment Management, Ltd. nor Pzena Investment Management, LLC nor the activities of any functionary with regard to either Pzena Investment Management, Ltd. or Pzena Investment Management, LLC are subject to the provisions of the Financial Services (Jersey) Law 1998.

For South African Investors Only:

Pzena Investment Management, LLC is an authorised financial services provider licensed by the South African Financial Sector Conduct Authority (licence nr: 49029).