ESG is a key component of bottom-up fundamental analysis. Engagement and improvement can drive value creation and lead to successful investment outcomes.

Environmental, Social and Governance (ESG) rose to prominence in the asset management industry relatively unquestioned. Recently, opinions on the topic have become increasingly polarized. We do not subscribe to either extreme: that investors should pursue special interest group agendas no matter the cost to companies, or that considering ESG is damaging to investment outcomes. Against the backdrop of the ESG debate, we thought it would be helpful to get back to the foundations of ESG and why we continue to pursue ESG integration.

Fundamentally, this comes down to the philosophical alignment between the principles of a value investor and ESG integration. ESG integration simply means considering a sub-set of issues that can become financially material and, in such cases, become relevant to investment outcomes. As such, our investment research would be incomplete without appropriate consideration of material ESG issues. ESG integration at Pzena is about fully understanding the value opportunity at stake for a given company and, through active ownership, engaging to create long-term value.

Below are some of our core philosophical beliefs as a value investor, and we highlight the inherent compatibility with ESG integration.

1. **Temporary Difficulty:** Undervalued stocks typically experience some kind of difficulty; hence they trade at a discount to the rest of the market. The possible reasons for a depressed valuation are numerous, including that the company faces ESG issues or has mismanaged its exposure to ESG risk. Fundamental bottom-up research enables us to make informed judgements about whether a company's difficulty (ESG or otherwise) is temporary or permanent, and whether we can envision a path to earnings recovery.

2. **Improvement Opportunity:** Once the source of difficulty has been identified, value investors must assess the embedded opportunity. Value investing offers an opportunity to buy a good business "on sale". Usually, the opportunity exists because the business is undergoing a temporary setback, such as declining earnings. For those companies that are also ESG laggards, part of the investment opportunity can be the potential for future improvement in material ESG dimensions, which can benefit business constituents, including shareholders. In this sense, we do not believe in inherently "bad" or "good" ESG companies. What matters is the embedded opportunity to improve.

Hon Hai

In December 2022, we made the decision to add Hon Hai to the Opportunity List given the escalating number of labor-related controversies. As a mobilizer of a large low-cost labor force, labor is both a critical business resource and potential risk factor for Hon Hai. From a business perspective, ensuring a supply chain that meets international standards is critical to the long-term success of Hon Hai. We therefore consider social issues a tail risk that we need to continue to monitor. Several highly publicized labor-related controversies have occurred in the last three years. While we are disappointed to see a recurrence of labor-related issues, we are pleased that Hon Hai is now more proactive in disclosing information and discussing these incidents with shareholders. We maintain an ongoing dialogue with the company on labor issues and continue to assess the risk of Hon Hai losing market share.

Alibaba

Alibaba has a history of governance lapses which contributed to our decision to add it to the Opportunity List in Q4 2021. These have included issues related to business ethics and related party transactions, as evidenced by the partial transfer of control of Ant Group to Jack Ma in 2011. Given Alibaba's history, we feel that continued responsiveness to shareholder concerns and the passage of time without incident will be the best measurement of their progress on ethics and governance.

CONCLUSION

At Pzena, our focus will always be on the material issues facing a company, ESG or otherwise, that may be contributing to current underperformance. If those issues are temporary and/or can be remediated, the company may be an interesting investment opportunity. The Opportunity List consists of a subset of our portfolio companies where ESG issues are among the most material issues facing the company. Improvement in these ESG issues, aided by our engagement efforts, could therefore lead to improvement in company earnings. However, there is no guarantee of ESG improvement for companies on the Opportunity List and they may remain on the Opportunity List for a range of timeframes. Regardless of outcome, we maintain that the most important thing is to continue to advocate for change if we believe it is in the interests of long-term shareholders to do so.

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