Andy: Hello and a very warm welcome to the Pzena Perspectives podcast. My name is Andy Williams and I'm a director of client and portfolio services based in our London office. On today's episode, I'm thrilled to be joined by Rachel Segal and John Goetz. Rachel is our head of ESG and has been with the firm since 2019. John is our co-chief investment officer and is also a co-portfolio manager on the global, international, European, and Japan focused value strategies. John joined Pzena back in 1996, which means he's just celebrated 30 years with the firm. Rachel and John, it's fantastic to have you on the podcast.

Before we get into it, I think it's only right for me to extend my warmest congratulations to John for reaching that milestone. Thank you, Rachel. I'd like to start with you if I may. You head of ESG is a very familiar job title to many, but what it means varies wildly from firm to firm. So, what exactly does head of ESG mean at Pzena?

Rachel: Great. Thank you. Andy. Um, well, simply put, I think it really means that I help to oversee the integration of financially material, environmental, social, and governance issues into the research and investment process. But you can really think of our investment team as our ESG team in the sense that we expect the respective analysts, the portfolio managers to really own the financially material issues for every company and industry that they're responsible for. And that would of course include ESG issues where they are in fact financially material.

So as the ESG team, we're really more of internal consultants helping the rest of the investment team go in some cases a little bit deeper or broader into the subset of of business issues that fall under the ESG umbrella.

Andy: Thank you. I think that's a really helpful framing for our listeners. If I look back over the last couple of years, I think there's been a really pervasive narrative around ESG retrenchment. you know, we've seen some companies stepping back from their commitments. We've seen some political push back. Uh we've even seen some investors questioning whether, you know, any of this uh still matters. So, turning to you, John, could you explain how we're navigating this environment given the fact that we integrate ESG into our investment process? Uh and we take a long-term view.

John: Yeah, let's let me just start by saying nothing's changed. Uh but Andy to your point, three years ago, you know, my day job basically involves talking to companies, making investments, talking to clients. Three years ago, ESG sustainability would come up every single conversation. And just in the last year, I just had a big swing through parts of Asia as well as Europe. And I would tell you that conversation just isn't happening with the same frequency. uh not that it isn't happening at all, it's just not happening with the same frequency.

So things are a little bit different in terms of the environment that we're dealing with and communicating on on ESG and sustainability. But what hasn't changed is our process. Uh as Rachel alluded to, uh we actually integrate ESG and the whole concept of us and our style is to make good long-term investments. And when I say long-term investments, I don't mean 6 months. I mean 3, five, 10 years. So the concept of doing the right thing and making sustainable investments doesn't change a bit in in in this uh political uh environment.

John: What I'll say is the environment and what people talk about changes, but what we do doesn't change. Our investment process uh is is a long-term oriented process. Uh we can acknowledge that sometimes good investment returns and what I'll call good goals for society or just doing the right thing can seem to be in conflict. You as investors we have to resolve that with analysis. Uh we'll give you some examples of that later uh in this podcast.

But but what I wanted to say is when we go at it with investment, we can't give up on our fiduciary responsibility. So we have to be pursuing uh good and adequate returns for investors and we encourage our companies to do the same. Uh ultimately there can be issues that need to be resolved and we might pause our investment if those are unresolvable. So for a quick example, I'll talk a little bit about about it more later is automotive regulation uh where we're trying to convert the entire fleet of cars to uh EV from combustion engine. There may be irreconcilable uh issues between regulation and good investment returns.

Andy: Okay, thank you. That's a really important distinction, uh, I think, and it segues really nicely into, uh, a paper that we've we've just published on on climate policy. Um, Rachel, you were the architect and primary author of this. Uh, I highly recommend all of our listeners have a proper read of it, and we'll we'll provide a link to it into the in the show notes as well. My question for you, slightly provocative one, is, you know, why write this piece now? Uh and perhaps even more bluntly, you know, why should investors care about climate policy?

Rachel: Well, it's interesting because in in a way I think investors should have always cared about climate policy and should continue to care about climate policy and and the reason for that is really I think it comes down to a sort of a timeline question. Meaning that if you think about what is climate policy meant to achieve, it's really meant to uh address some of the long-term effects of climate change typically in the form of some kind of decarbonization pathway for the economy. And that's over an extremely long time scale that we would expect to see these effects play out.

I mean, climate change is a not even decadal but multidecadal event. And um then when you think about the timelines over which policy makers operate and indeed companies operate, you're talking about much shorter term time frames. And in fact, even the the capital cycle and the political cycle don't often align in terms of time frame either. And so when you think about how those three things interact and that the the mismatch of time frame between the three of them, I think that's where investment risk can lie. And that's certainly what we've observed.

And so when we talk about climate policy, we're not really talking about it from the advocacy perspective. We're talking about it from what is a potential investment risk or indeed opportunity that we need to diligence as part of our integrated approach. And then when you sort of talk about why now, I mean it's a good question because in theory we could have done this podcast a few years ago or even, you know, in the future.

Rachel: But I think there's this element of the sort of shifting um political landscape that John was alluding to that has caused some of the you know the the policy that's in place to shift and change along with that and that's creating waves for companies implications for companies and that can have a meaningful impact on capital allocation decisions and um what we try to sort of stay on top of is of course you know how that evolution may affect the investments that we're making and so I think from that perspective the the change in the political environments around the world is sort of makes this quite a timely topic for right now.

Andy: Okay, that's really interesting. I hadn't quite appreciated the framing of those three cycles and the how they're interconnected and potentially the mismatch between the horizons is very interesting. It makes me think actually when you've engaged with companies on climate policy. Were there any um impressions that that that you got from the companies that you think are worthwhile sharing or indeed that were surprising to you?

Rachel: Yeah, it's interesting actually because I I think what surprised me the most when we embarked on this exercise and delving a little bit deeper with companies into their thoughts on climate policy was actually the surprise that they had that we wanted to have the conversation and it was sort of clear that you know it may not be a topic that um many investors want to go into that level of detail with them about. And actually as the conversations progressed, we were meeting with teams who were more internally focused um working on these issues day-to-day who typically don't interface with investors at all.

And so I think from the company's standpoint, they were actually thrilled to be having this conversation and sort of really welcomed the interest from the investor community and sort of I think we both realized that actually this was a conversation that we should be having even you know more readily more frequently um than even we had been. So I think that was particularly interesting.

And then kind of connected to that, I think there was also um a little bit of of surprise on our part that there was such consistent insights and feedback from these conversations. I think when we embarked on this project, we weren't quite sure if we were going to get 15 different answers to our questions given the sort of range of companies and industries that we were engaging with. But actually uh in the end the the article wrote itself very easily because I think you know we we saw a lot of alignment across the conversations but also a lot of alignment with how we think about these issues internally as well.

Andy: Yeah, I can see how that consistency and answers would be been very helpful when when putting this article together and in the paper uh we identify three ways in which climate policy can fail. So when it's too aggressive uh when it's too abstract uh and when an investment outcome becomes overly reliant on it. I think this is a good time to bring it sort of back towards uh towards an investment and perhaps uh touch on a specific example. So perhaps a question for you John, how have you seen some of these particular challenges you know manifest in our investment research?

John: Yeah, let's take that aggressive too aggressive point first. uh certainly over the last 10 years I think the view of the regulation that was required to clean up the steel industry just to pick on a much maligned industry over the last 10 years the the aggression there was about decarbonizing steel uh and and certainly some regulation to help us get to that long term that Rachel was talking about uh that might be multidecadal change some regulation is required.

But what happened was Europe shot ahead in terms of creating regulation on carbon-free steel and the world is a steel business if you will. Uh steel isn't limited to Europe. So as soon as you start dealing with a global industry like steel and imposing regulations on one part of the geography, things get messy. So let me talk about ArcelorMittal. ArcelorMittal is a global steel company huge operations in India, Europe, Latin America, North America. So basically it's a global steel company quite well-run. Uh and when they face these regulations and you looked at the the need to decarbonize steel, those investments are in the billions of dollars.

Um, so when when investors saw Europe shooting ahead, and I'll talk a little bit more about how those regulations are changing, but when they saw Europe shooting ahead with aggression, what the investment community decided was steel in Europe is dead. By the time we're we're value investors, so we're looking at industries that have lots of controversy embedded in the valuations. And by the time we undertook this project, the steel industry and ArcelorMittal stock in particular had been so beaten up that essentially the European operations were viewed as zeros by the market.

Now that raises an interesting point. Aggressive regulation and the consequences for the stocks can actually create opportunities. So what we saw in this was an opportunity only one of two possibilities. the regulation takes a smarter long-term path or the stock reflects all the pain already. So, the downside is actually limited. So, I wanted to just put that out to everyone to realize that changes in regulation, even if they're super aggressive, doesn't mean there aren't investment opportunities.

So, what happened here was the regulation shot forward in Europe. the investment community basically panicked uh and as a consequence we got involved with the company. Now here's where the dialogue with the company becomes important as Rachel was was alluding to. We're not going to go to an investment and not understand their plan. And in ArcelorMittal they had what we thought was a very prudent plan which was don't immediately start making billions of dollars investments if we think Chinese steel can just stream across the border into Europe.

And initially uh what they call the CBAM adjustments, the carbon border adjustment mechanism was really like Swiss cheese. I it didn't really prevent the long-term impacts of Chinese steel or Russian steel from, you know, taking over Europe. So what what we agreed with ArcelorMittal on is that they needed to go slowly in terms of the adjustments to decarbonize European steel. And over time it has gotten better and in fact the recent adjustments in in the carbon border adjustment actually make more sense.

So now all of a sudden the stock is responding more positively to the fact that maybe European production is still in the game. Uh it's also very interesting to me that all of a sudden steel is required to build data centers and other infrastructure and and people are now positive on demand for steel again too. So these two positives have come back and in fact the stock is is already basically where we hoped it would be. So I just wanted to put that out there to the audience to realize that lots of things are always going on but overaggressive regulation can really spoil the spoil the short term for these businesses.

Um now now I do want to add one point just because ArcelorMittal went slowly in this journey towards investing to make carbon-free steel in Europe doesn't mean doing nothing is okay. This is where you know working with our ESG team we do want the long term to be a better place for the environment than than today. But ArcelorMittal is doing things. So, for example, they have a project right now to take exhaust gases from the blast furnaces and and take out the hydrogen and turn that into a clean fuel for other use within Europe. So, so I would say that yes, there's things to do, but racing to decarbonize steel and spend all that capital probably would not have been a good investment tradeoff. So, we were with them on going slow on this.

Andy: So the to to par that back the policy created uh basically created the undervaluation of the company. What's really interesting about that is ArcelorMittal clearly took a more pragmatic view given the geographical mismatch that you mentioned. Now is that is that a typical management response? Are you seeing any other management teams um you know push back on policy in that way or or or suggesting a more pragmatic way forward?

John: Yeah, absolutely. I mean what's interesting is we're global investors so we end up actually investing in a lot of global companies actually and and so if you think about automotive in Europe it's been a nightmare just just pick up any stock price chart you'll see what I'm talking about uh and the controversy there is pretty simple again European regulations suggested that by 2035 we should have no carbon uh consuming engines to power automotive of uh industry in in in Europe.

Well, the reality is the consumers weren't ready for the cost of that. So, if you interviewed a new car buyer and say, "Hey, how do you feel about paying 50% more for your new cars?" They would have said, "What are you talking about? I'm already tapped out." So, so clearly the consumption side was messed up. But on the production side, uh Europe needed to completely retool to make these EVs. And there are billions of dollars of capital spent. Uh a lot of that money's already been spent. So I'm not saying that automotive industry isn't changing in Europe. Unlike the steel industry, they moved fast on this. But what it did was it ate up tons of cash flow and created a real nightmare uh for for the industry.

And at the same time, the Chinese battery industry was subsidized. So, China has a head start on EVs and they're just pummeling uh the pricing of EVs that are now coming out of Europe. So, yes, management there in the auto industry is in dialogue and I do think we're having some progress made in terms of delaying certain requirements or standards so that the industry and the consumers can catch up uh to the long-term reality of carbon-free vehicles.

Andy: I think those are both fantastic examples as to why uh why being mindful of climate policy and why doing this work is so important. I think we've you know we've covered the issues that happens when investments become overly reliant on it. Rachel, turning back to the article, we also touch on a couple of other challenges that policy can be too abstract or that companies can become too reliant on it. Please could you give us a quick overview of of those two?

Rachel: Sure. Yeah. So what do we mean when we say climate policy can be too abstract? Really what we're saying there is that climate policy can exist at a high level in terms of targets typically um decarbonization by a certain future date. But what we've observed um is that actually the you know in order to scale some of these clean tech earlier stage technologies that we've been alluding to you really need quite a complex set of granular policy incentives also supporting infrastructure and market demand to be incentivized. And absent that you can end up kind of really without the supportive market environment for for these technologies to scale.

And so when companies try to maybe get out ahead of of where the market is today with respect to policy and demand environment, we see them run into challenges and it can impact their returns and then ultimately shareholder returns over over the long term. And one of the classic cases of this that we refer to in the article is is BP in 2020 when they launched what they term sort of reinvent uh BP which was meant to be quite a drastic departure in their energy transition strategy going very quickly towards a net zero future prioritizing renewables and other clean sources of energy over their existing oil and gas business. And ultimately that decision didn't pay off. they've since had to walk that back and it it has really uh led to challenges for them over the years since and and so that's sort of an example of when a company maybe wants to do the right thing or what they perceive to be the right thing but ultimately does it in such a way which is too far ahead of of where the policy environment is in the given moment.

Um, so that that's sort of challenge number two. And then challenge number three is sort of where companies can become too reliant on climate policy. And this really only translates into an investment risk when that policy then changes. And so if if the particular technology or project was really dependent on a specific set of policy incentives and those either go away or change over time, that can obviously lead to problems for companies that have made kind of long-term capital allocation decisions. assuming a level of stability that then doesn't materialize.

And so in the article we refer to a couple of cases where this has happened because we observe it to be actually quite a global phenomenon, not you know necessarily um targeted in specific regions and oftentimes it can happen in in geographies where there's historically been quite a lot of support for climate policy. That policy can fall away either rapidly or or over time and so we compare and contrast a couple of examples there. one in the US focused on offshore wind and what's happened there recently with some of the quite um sudden reversals of policy support that's led to stop work orders and challenges for companies that had made long-term investments there and then also in the UK with a project that Drax uh has been working on now for many years in um in bio energy and carbon capture and storage where policy incentives specifically subsidies have over time fallen away which have put some of the future project economics into question and and there is some debate whether that project can continue to be developed to the fullest extent that was planned. Um so that's just kind of a couple of examples I would encourage listeners to to maybe read in more detail in the article that we put out.

Andy: Well, I think anybody who's listening to this in the UK will certainly remember BP's Beyond Petroleum campaign uh and and sort of how that how that all turned out. Um build on a more serious note. I mean those are quite serious flaws in climate policy uh to create such you know misallocation of capital. Um so what does better policy look like?

Rachel: Yeah. So we we propose three different ideas for that which is sort of based on obviously what we think internally but also was very consistent in the conversations that we had with companies. So the first there is really about making sure we don't forget about the demand side of the equation. So sort of historically a lot of climate policy for whatever reason has seemed to focus more on the supply side and and that might involve you know specific project-based incentives for specific types of technology things like carbon capture or hydrogen plants. And while that can be effective and certainly can incentivize companies to develop those projects, if there isn't then the end demand from customers for whatever product or service um they're producing, then that leaves the companies in a difficult situation. And ultimately, if they're doing their planning correctly, they would elect not to build those projects because they would see that that would be a challenge for them in the future. And so, we want to make sure that policy continues to remember that there needs to be demand for products if it's going to to be successful.

Um, number two, I think um there's there's a need for for climate policy to be stable, and I think we've touched on that theme a number of times in this conversation, but it's really difficult for long-term capital planning if you don't know the rules of the game that you're operating in. and and actually one positive example from our portfolio. So Dow has um frequently cited the success of its Alberta net-zero cracker actually first in the world um being tied in part to the policy stability that the Canadian government has afforded them in in getting that project off the ground and creating a stable operating environment. So we think that's really quite foundational to to a lot of project success.

And then lastly, just this idea that policy should be more cross-border, collaborative, and ideally global in nature.

I don't think we're maybe naive enough to think that there'll be a global price on carbon anytime soon, but we are starting to see some positive signs of considering the bigger picture when um developing a policy or set of policy requirements and also just collaboration between countries and different companies in in the sort of acknowledgement that this is a global problem. Climate change is not one country's problem to solve. And there's a good example that we refer to in the article related to the Northern Lights carbon capture and storage project that's going on in Europe, which is really a collaboration of multiple countries and companies taking carbon uh from industrial sites around Europe and transporting it to a single storage facility. And the sort of scale that that project's able to provide has meant that the economics can be attractive and so we want to see more of of those kinds of projects moving forward.

Andy: Well, very I sincerely hope that we have some policy makers uh listening to this podcast because they will sound uh very sensible and will make will make our lives much easier. But let's bring this back to how these assessments really show up in our portfolios. So turning back to you John, you know, how does all of this shape how you think about allocating capital in companies that that are exposed to this climate policy risk, you know, in one way or another?

John: Yeah. Well, there's no easy broad answer to that question, Andy. As you know, it's all case by case. Uh, and what I'll do is I'll kind of lay out the facts that our business is trying to find undervalued situations, right? We're trying to find companies where some uh issue or pain has created a low price relative to what the long-term future looks like. That's what deep value investing looks like. Sometimes the controversy itself is wrapped up in what we've been talking about policy policy that was just came in or policy that's been grinding away for a while uh in a very negative way.

So there's two parts to it. One is does the stock price reflect the maximum pain associated with the environment that they're in. So so that's what we're looking at. But then there's an embedded part about what is the company doing in this situation. Uh Rachel gave the example of BP where they charged forward with a plan that was destroying value. And that's the other part we have to evaluate is the company's plan to spend capital and use the cash flow of the business prudent or imprudent and and in that part uh we have a lot of dialogue and we have to think long term.

I I've said longterm a couple of times. I know already. Rachel said longterm a couple times. And what we have to do is not immediately react thinking that what today looks like is the permanent uh state of affairs. Uh and again the capital spending plan uh for BP went off track but then came back on track. So we also have to be fluid in our understanding of what the company plans are. But as fiduciaries of our clients money, the number one thing is the price of the stock has to make sense and their capital plan has to make economic sense. It's wonderful to think that our wishes for our environment and the company making money are easy to to mesh together, but that isn't necessarily so. with our fiduciary responsibility. That means if they have a plan that sounds wonderful, we're going to fix the world in whatever form that takes, but it's not economic for shareholders. We have to first oppose that plan or not invest in the company. Uh so I think that's the way I would frame it uh for our our listeners here.

Andy: Fantastic. And well, really what I'm hearing there is that it's almost as if that the way that both you describe the dialogue that you've had, you know, between companies and some of the companies you you've mentioned is it really feels like a lot of this has has kind of grown up in in many senses and we're sort of out those teenage years and you're actually having much more sensible conversations about capital allocation uh and you know a more uh you know reasonable and and practical path to to some of these goals. So my take is this is this is very positive.

Before I before I let you both go, I have a question uh for for each of you. Um if you could just change one thing about how climate policy works today. Uh what would it be? Uh and perhaps we'll start with you Rachel.

Rachel: Gosh, one thing. Um well, I think it sort of comes down to this point that we've touched on a number of times in the discussion, but maybe to move away from trying to regulate the specifics of the what. So the technology and the projects and thinking more technology agnostic pricing carbon in some form whether that's directly or as a sort of embedded emissions within products that is allowable or not allowable and that should in theory if the markets are doing their job sort of price things effectively to allow innovation to occur and I think our view is that there's no one solution to this problem there's no one technology that's going to solve climate change and each individual company specific project specific sight specific nuance needs to be accounted for and the only way that that can happen is if you allow the markets to sort of do what they do best in in theory. Um that's what I would say.

Andy: Thank you Rachel. Over to you John.

John: Yeah I I'm going to repeat myself. Think long term. Okay. I think that thinking long term involves more than reacting emotionally to desires or things that sound good. Uh, you know, I I would love a world where everything we wanted emotionally was financially viable, but that's just not reality. So, when you think long term, what I'm talking about here is both as a company, what is a sustainable idea? What is sustainable regulation? What is sustainable for our customers? That sustainability word is super relevant to us because we're long-term investors. But you have to be thinking long-term with respect to to policy. It can't be emotionally darting from left to right and changing regulation, which is the point you made, Rachel, because then the companies just can't act at all.

Um so even our regulation I'll just throw our tariffs under the bus here just for for a second right uh changes in tariff are just paralyzing companies in their investment plans but the same is true with respect to environmental uh regulations. So so my hope is that we can think about second order effects before we put things in place. That would be my hope uh for our long run future.

Andy: Fantastic. Well, I've thoroughly enjoyed this conversation. Uh I hope you both have too. You've been consummate guests. I've certainly learned an awful lot. Uh I'm sure our listeners did too. And I just encourage everybody again uh to check out uh that article uh in the show notes on our website. Uh but that's all from us for now. So John Rachel, thank you. Uh and uh we'll hope our listeners tune in again next time.

Rachel: Thank you.

John: Thank you.