Quantum Leads the Way on ESG in India

Excerpt from the Annual Letter of Quantum Mutual Fund

P for Profit - or Perpetual Prosperity?

While policies that governments enact may have an impact on society immediately and can be reversed by a subsequent government - or a change in thinking of the same government – the behavior and actions of companies can have a more lasting impact on society. The average life of a listed Indian company far outnumbers the life-span of a typical government or even the duration of reign in power of a ruling party. And, while governments are voted in or out of power in a transparent and democratic way where the people at large have a say, the election of CEOs and nominations of Board members who oversee the companies are not open for discussion to the public at large and, in most cases, even the shareholders are unaware of the election process. Individual shareholders don't really cast a vote for a Member of the Board or for the CEO – and they have little opportunity to ask what the candidates stand for, besides the obvious objective of making money (most of the time, for themselves!).

Neither do institutional shareholders give much thought to the selection of the CEO or the Members of the Board when they cast their votes. Hence, in the form of capitalism that exists today, analyzing what companies do and how they behave may be more important than worrying about what governments do.

It is true that the share price of companies is set by market forces. But it is also true that the share can be "mis-priced" as a vast majority of investors in shares (whose buy or sell decisions set the price) mostly focuses on a quarterly profit number or some near-term exciting metric that is marketed to them. Hence, the long term impact of all the *masti* a company is doing is largely ignored by a very short-term oriented market.

25 years of following "G" for Governance.

At Quantum Advisors, we began to adopt a "Governance" factor in our investment decisions after October 1994 – so this is the 25th year anniversary of us adopting a "Governance" filter.

In 1989, a year before the creation of Quantum Advisors a gentleman from South Africa (sadly, I cannot recall his name!) asked me: "What would you like to do?"

"Manage money", I said.

To which his response was, "One bit of advice, young man: If you shake someone's hand and don't get your five fingers back, don't shake their hand again!"

That seemed like a strange advice for someone setting up a research and investment firm but, like most parables, these hit home when you least expect them to!

I learnt a bitter lesson in October 1994. Reliance was the largest holding in the approximately USD 1.4 billion Jardine Fleming family of funds that I helped manage. India had "opened up" its economy and my partnership with Jardine Fleming had made us the most successful financial firm in India. In October 1994, literally weeks after placing a large chunk of their shares with Unit Trust of India - the accommodating buyer of first and last resort in the stock markets - Reliance announced a merger of their listed "twins" into the parent company at a ratio that did not seem favourable to shareholders of the main Reliance company, but seemed very favourable to the shareholders of the twins. The Ambani families were shareholders in the main company and in the "twins", Jardine Fleming India funds was not a shareholder in the "twins". We had shaken their hands and not been treated fairly.

The list of managements who tend to treat non-family, non-promoter shareholders with disdain and impunity has only increased over the years. Many founders believe they have some God-given right to extract whatever they want, whenever they want, however they want – at the cost of the other shareholders. The boards of many of these companies are mostly manned by agreeable yes-people, many of them well-paid. Our "Governance" filters stop us from buying into such companies and, if we discover a company has poor governance *after* we have bought the shares (Ranbaxy as a case in point) we have made our feelings known to the management. If they don't change their course of action – and believe me the large, established, arrogant groups have no desire to change – then we have sold our shares and added these founders to a rapidly growing blacklist: this is a list of founders that we are not likely to invest your savings with.

Now adding Environmental and Social factors.
Our long term returns have not been compromised by this practice of filtering companies for "Governance". One could argue that the risk we have taken on behalf of our investors has been reduced by such a filter. Number-crunchers like us need to quantify everything and place them in cute formulae and neat boxes. Hence, the financial industry defines risk as volatility which, in actual fact only measures the extent to which a share price moves up and down on any given time period. Volatility is not Risk and Risk is not Volatility. Satyam may have been a low volatility stock (not much up or down movement in its share price) but it had an inherent risk of a crooked management which finally blew up and decimated the wealth of its investors.

While we have followed this G filter for 25 years as a group, we had not focused on two other aspects that have emerged to the centre-stage in the discussion on corporate behaviour over the past decade:

(i) E - Environment = how does the company's business, its factories, its products – impact the Environment. Air pollution, water pollution and deforestation are costs that are borne by society as a whole and, one day, the Company may be forced to pay fines for their past misdeeds;

(ii) S - Social = how does the company's internal and external policies support the desire for a more equitable and fair Society. Should cigarette manufacturers pay for health costs because the products it sells can cause cancer? Should textile companies hire suppliers who use child labour and make their staff work in cramped, unhygienic and life-threatening conditions?

Over the next few years you will read about – and be more concerned about - these ESG factors.

Since 2014, Quantum Advisorshas begun to spend more time on the E and S: factors that we had not considered in the past. After asking third-party suppliers of ESG reports for sample reports of companies which we felt would fail our internal G filters, we realized there was a mismatch between how these external suppliers rated a company on ESG criteria and how we rated them. It is not that one method is superior to the other or one has proven to be better than another – ESG is an evolving science. But we do understand a fair amount of G and the views from these external vendors on the G of many companies did not work for us. So we decided to build our own team and develop our own database of rating the Companies on ESG scores.

ESG is imperfect and is evolving.
ESG, evolving and nebulous as it is, has come in for criticism by many, including Commissioner Hester Peirce, of the Securities Exchange Commission of USA. In a recent speech on June 18, 2019 delivered to the American Enterprise Institute (a think tank that tends to believe that lower taxes and less regulation is the best way forward for society) Commissioner Peirce – with the careful disclaimer that the views represent her personal views and not that of her fellow Commissioners or the SEC – likened the ESG rating system and the supplier-user chain that has been rapidly built up in the investment management industry akin to the novel "Scarlett Letter" by Nathaniel Hawthorne where a unmarried mother of a girl was forced to wear the letter "A" to identify her as an Adulteress – even though her actions were morally superior than many who had branded her as immoral. An extract from Commissioner Hester Peirce's speech:

"We are seeing a similar scarlet letter phenomenon in today's modern, but no less flawed world. In these remarks, I will focus specifically on the way in which corporations are being assessed according to

Environmental, Social, and Governance (ESG) factors. Here too we see labeling based on incomplete information, public shaming, and shunning wrapped in moral rhetoric preached with cold-hearted, self-righteous oblivion to the consequences, which ultimately fall on real people. In our purportedly enlightened era, we pin scarlet letters on allegedly offending corporations without bothering much about facts and circumstances and seemingly without caring about the unwarranted harm such labeling can engender. After all, naming and shaming corporate villains is fun, trendy, and profitable."

While we fully respect the fact that information is not always available and may be incomplete, we believe that recent rules that force companies to disclose more information on these ESG factors and a history of such data will allow us to try and avoid shocks and disasters in the portfolios which you invest in. More data over time will allow for a better evaluation of the impact that companies are likely to have on the environment and on society in general. ESG like beauty lies in the eyes of the beholder and, like wisdom, improves with experience. Because wisdom or ESG cannot be measured accurately, does not mean that it is to be ignored.

Despite the early stages of the evolution of ESG we take our work seriously and don't see ourselves as part of a food chain in the ethically challenged financial industry. The habits of the revenue-eager financial services firms do not make the practice of pursuing an ESG scoring system immoral or bad. Since corporations outlive governments and - in some instances - control governments, it is our belief that we should know how these companies are run, what kind of policies they adopt from the perspective of smaller shareholders who own a minority position and what can be their impact on society and, more specifically, on the environment.

There is no one answer and there is no perfect solution - but some glaring lies can be exposed very quickly.

I remain confident that Quantum will not let you down in terms of an ingrained, ethical framework and in terms of its deliberate, reasoned investment solutions. Backed by the strength of several years building out our in-house ESG capabilities and proprietary scoring system, Quantum is poised to be at the forefront of advancing these principles across India.

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