



ESG und Aktien Small Cap

Q4 2018



TELOS GmbH

ESG and Smaller Companies

The Rise of ESG

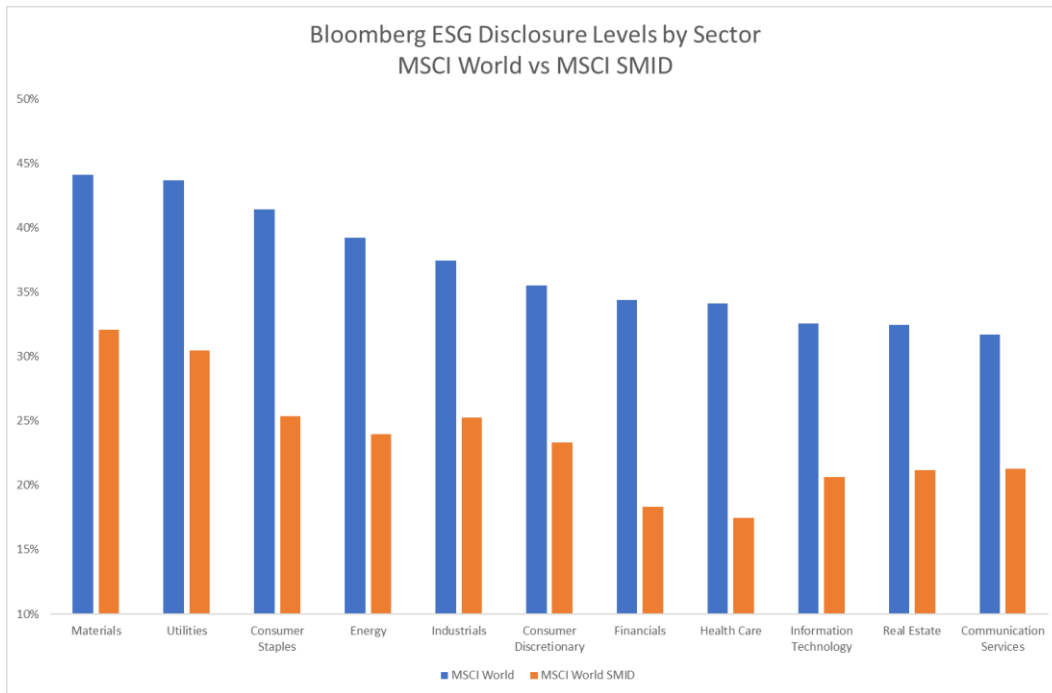
It is hard to ignore the increasing importance of Environmental, Social & Governance (ESG) influences in investing however the space can often be confusing. In this article, we explore the landscape for smaller companies and discuss how Davy Asset Management (DAM) incorporates ESG into our “Quantamental” (Quantitative & Fundamental) investment process, focused on identifying high Quality businesses, as defined in our investment approach (Source: Davy Asset Management - “Quality Matters” White Paper – Chantal Brennan, Paraic Ryan, Hannah Cooney: 2016). Since 1926, the Davy Group has provided bespoke responsible investment solutions. Davy Asset Management continues this commitment with a focus on meaningful risk-adjusted returns.

As investors we take an integrated approach to Quality investing using a combination of both financial and non-financial data to identify sustainable business models. In this article, we will discuss how ESG reporting has improved among corporates, how we integrate it into our research process and why engagement with company management is important particularly for stocks in the smaller companies’ space.

In recent years, the number of companies publishing ESG reports has grown rapidly across regions, sectors and the market capitalisation spectrum. Firms are increasingly disclosing information on factors such as carbon emissions, social policies, board structure and pay packages and building these considerations into their strategic plans as it helps them better assess potential business risks. A sustainable enterprise is one whose earnings and cash flows enable them to grow over time without exhausting the level of resources available to them. The firm is self-supporting, creating value for all stakeholders, i.e. shareholders, employees, suppliers, distributors and the communities where they operate. As a result, we believe it’s better positioned to anticipate and react to changes in the economy.

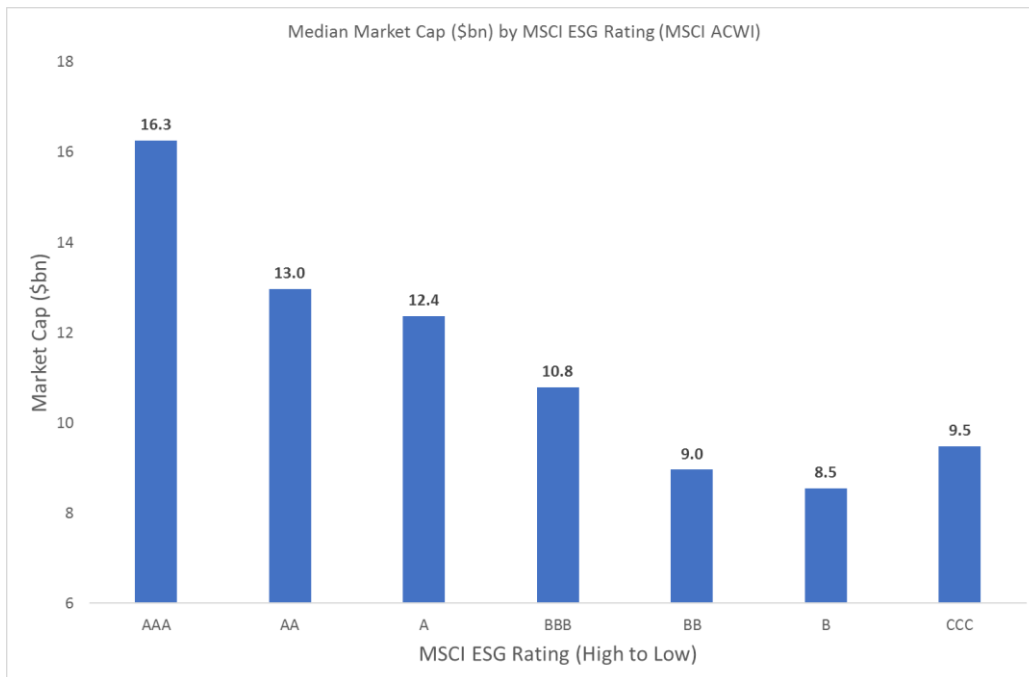
ESG and Smaller Companies

Despite ESG being a hot topic, many companies on a global basis still don’t provide a high degree of disclosure as reporting is not only time consuming and costly but also voluntary. Davy Asset Management’s database consists of approximately 8,000+ developed market companies, which includes around 6,000 smaller ones whose market capitalisations are less than \$15bn. What we see is that companies with larger market capitalisations tend to provide greater details about their ESG policies than small-cap companies. This can be seen in the chart below where large companies tend to have better ESG disclosure scores. Disclosure tends to be best in the most highly regulated industries such as Materials, Utilities, Consumer Staples and Energy. Given that some of these constitute dirty industries, disclosure alone is not a perfect measure of how “ESG” an industry is. What is important is that disclosure levels have been steadily increasing over time.



Source: Davy Asset Management, Bloomberg, November 2018

More importantly, we should consider ESG research and engagement as part of the process to facilitate awareness of business risks and ultimately, improvement in ESG ratings. On the face of it, as can be seen in the chart below, when we look at ESG Ratings, smaller companies don't appear to be as "ESG" as larger companies. We don't believe however this is the case.

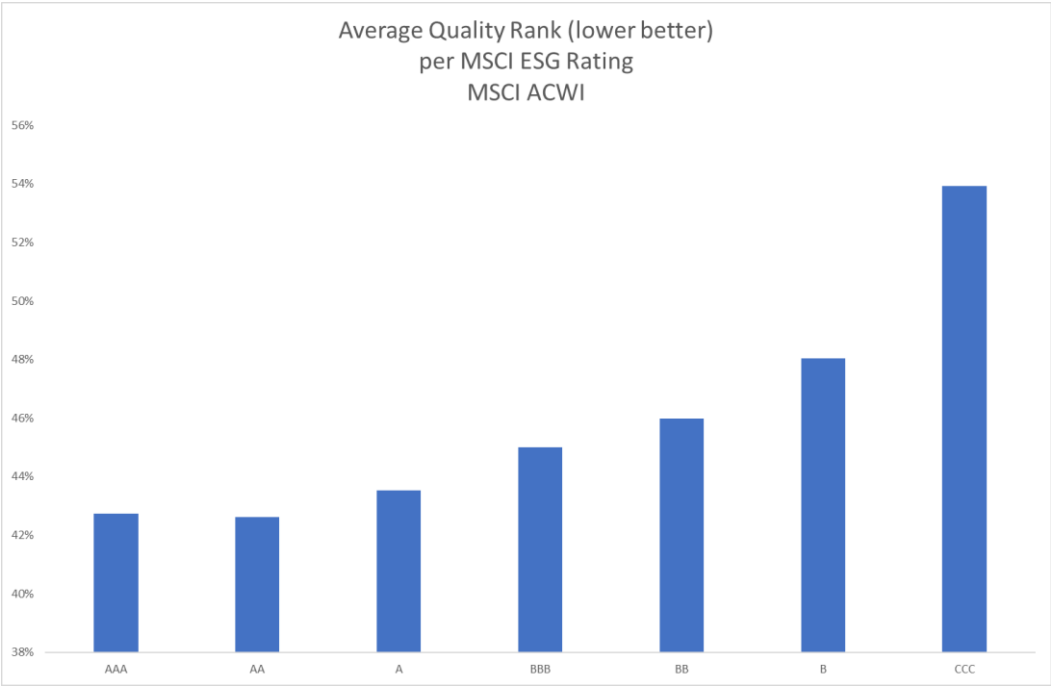


Source: Davy Asset Management, MSCI, Bloomberg, November 2018

How does Davy Asset Management consider ESG?

At Davy Asset Management, we take a pragmatic approach to the space and understand the limitations facing smaller companies. We don't believe that smaller companies are fundamentally less "ESG" in nature and recognise that they are probably more focused on growing their core business. What we can focus on is identifying high Quality smaller businesses and actively engaging with these companies on the ESG issues and the business risks they face.

We find that one of the best ways to identify companies which are more likely to display positive ESG characteristics, is by focusing on identifying high Quality companies as defined by our four-pillar approach (Profitability, Persistence, Protection & People). The connection between ESG and Quality is intuitive, i.e. good ESG policies should serve as a proxy for quality management, and a quality stock. When we look at our data, we find that companies with higher ESG scores as measured by MSCI, tend to correlate positively with those companies also displaying a favourable DAM Quality Rank; AAA companies, have the best (i.e. lowest) Quality rank where as those with CCC ratings have the highest (see chart below).



Source: Davy Asset Management, MSCI, Bloomberg, November 2018

In addition to identifying high Quality businesses, ESG is incorporated into our investment process through research and engagement. We integrate the data into our fundamental models by adjusting the cost of capital to reflect a firm's ESG characteristics. Second, through ongoing engagement with company management, we understand the business risks and exposures better and can therefore guide companies with regards to positive policies and procedures which they should have in place. Post investment, we reflect our views by proxy voting to steer companies towards more responsible decisions.

An example of a company which we engaged with was Republic Services Group, a US waste management company which was rated CCC by MSCI (low score) despite it being rated as a high-Quality company. Waste management is a highly regulated industry and a low rating

raised some serious issues. When we raised the issue with management we found they were working to improve their environmental management systems and subsequently, their rating rose to B. This case highlights the importance of identifying ESG risks, taking appropriate action and how corporate contact is an important aspect of the research process when investing in smaller companies. ESG can highlight business risks more traditional fundamental research does not. It is important to note however that engagement takes time and there may not be an immediate solution.

Davy Discovery Equity Fund

As we have outlined, at Davy Asset Management we focus on Quality with our strategies adopting a “Quantamental” investment process, employing techniques from both quantitative and fundamental fields. Furthermore, ESG is woven through our process from how we value companies through to how we engage with them.

Our Global Smaller Companies Fund, the Davy Discovery Equity Fund, is a high conviction portfolio of high Quality, global smaller companies. It aims to benefit from the smaller companies affect with a bias towards Quality. As the fund invests in companies at an earlier stage of their life cycle, it is naturally exposed to the primary stages of secular trends and themes. Higher growth smaller businesses tend to be innovative and very entrepreneurial. They tend to be faster growing, offering focused products or services protected by high barriers to entry. The fund is currently exposed to trends such as; robotics, automation, wellness, artificial intelligence and the sharing economy.

The strong relative performance of the fund over the last three years we feel reflects our Quality focus. The Fund has achieved this with favourable risks metrics (volatility and drawdowns). Overall, we believe companies which are long term winners exhibit common identifiable characteristics or Quality factors. It is our view that the market systematically misprices the prospects of these companies and an investment process focused on identifying these opportunities, at the right valuation, will deliver superior risk adjusted performance over the long term. We have derived our own proprietary definition of Quality based on four the four pillars previously mentioned. Our objective is to find high Quality companies and employ rigorous portfolio construction to provide exposure to investments with higher and more sustainable returns. To accomplish our investment objective, we lever various data sources and have created an ecosystem of over 15,000 companies, all of which are ranked in terms of Quality as well as on Valuation and Growth to give a global view of the world without losing any information.

The experienced team, Chantal Brennan and Jeremy Humphries have successfully managed portfolios in this asset class over the course of their careers at PineBridge Investments and Schroders, respectively. Together they have created a robust portfolio based on a rigorous portfolio construction and risk management process.

Annual Returns (EUR)	2017	2016	2015	2014	2013
Republic Services Group (RSG US Equity)	6.1%	36.9%	25.2%	42.2%	11.6%
Davy Discovery Equity Fund (Net)	14.2%	10.0%	13.5%	14.7%	
MSCI World SMID	8.3%	13.7%	11.7%	18.6%	

The Davy Discovery Equity Fund was launched on 12th December 2014. Please note that the Davy Discovery Equity Fund (UCITS) is newly established. The past performance chart reflects past performance data relating to the Davy Discovery Equity Fund (non-UCITS) which merged with the Davy Discovery Equity Fund (UCITS) (the “Merger”). Prior to the Merger when the Fund was not authorised as a UCITS, the investment policy, strategy and portfolio composition were largely the same. In the circumstances, the past performance data included in this document is believed to be an appropriate reference.

WARNING: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up. This may be affected by changes in currency exchange rates.

PLEASE NOTE: This article is intended to be used as a helpful resource, strictly for information and discussion purposes only.

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PLEASE NOTE: Investors should also read the Prospectus, Supplement and Key Investor Information Document for the Davy Funds plc (the “Fund”) prior to making a decision to invest. Please also consult these documents for full information on the Fund including, fees, risks and conflicts of interest. These documents are available from Davy Asset Management, Davy House, 49 Dawson Street, Dublin 2 or listed on our website (<http://www.davyassetmanagement.com/>).

The Fund is an open-ended umbrella investment company with variable capital and segregated liability between sub funds incorporated with limited liability under the Companies Act 2014, authorised by the Central Bank of Ireland as a UCITS (Undertakings for Collective Investment in Transferable Securities) pursuant to the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011, (S.I. No. 352 of 2011), as may be amended, consolidated or substituted from time to time.

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