# The Parnassus View

## Practitioners' Perspectives on ESG and Performance

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*When Parnassus Investments was founded in 1984, many investors believed that using socially responsible investment criteria in stock selection was likely to weaken portfolio performance. Today, increasing numbers of investors recognize the value of evaluating companies using their environmental, social and governance (ESG) records. In this interview, Parnassus CIO Todd Ahlsten and Director of Research Matthew Gershuny share insights about the relationship between ESG analysis and stock performance based on their 36 years of combined ESG investment experience.*

### How has ESG investing evolved over the decades?

**Todd**: Socially responsible investing was originally all about values. Exclusionary screens were the primary strategy used to express beliefs about how to improve society, such as discouraging tobacco use. But there was not yet strong investor and consumer demand for responsible products, and companies certainly weren't seeing good environmental, social and governance practices as ways to improve their long-term performance.

Today, the question has shifted from "Can ESG keep up?" to "How much can managers who choose positive ESG performers outpace those who don't consider these issues?" And we are starting to see research that indicates a performance advantage over a number of years for ESG strategies.[1]

**Matt**: Many investors used to believe that values-based investing would deliver inferior returns by

limiting the number of companies that could be considered. Parnassus was founded in 1984 with the idea that this was not true. Investor opinions about ESG over the recent decades have changed significantly, in part due to performance delivered by the Parnassus funds. ESG investing is growing for two reasons. Understanding a company's ESG profile may open up financial opportunities, and people want to invest in companies that are helping to solve problems. As Todd said, some studies show correlations between ESG and fundamental performance, although we don't yet have precise ways to measure exactly how much ESG matters.

### How do you find companies with positive ESG profiles that are also good investments?

**Todd**: Companies use ESG-inspired innovation as a way to drive value, but I can't say exactly how much it matters to performance in any particular case, because it's just one aspect of the company's overall business practices. That's why we think it's so important to learn everything we can about a company before we invest. Businesses that offer products and services that can sustainably gain market share because they fill a need for consumers and society are likely to increase in relevancy over the long term. Leaders of these businesses are looking ahead and helping to decarbonize the economy and conserve resources, because they believe this will help their companies thrive in the future. They participate in sustainable megatrends – for example, the increasingly digital economy or new technology designed to conserve energy and water. Finally, their management teams lead with good governance, diversity and inclusion practices.

**Matt**: An example of a company we like is Xylem. We believe this company is positioned to do well as it becomes increasingly challenging to supply the world's population with enough clean water. Xylem boasts a portfolio of water-related products that is one of the strongest in the industry. The company emphasizes water efficiency, eliminating leaks and providing products and services that help communities increase their access to water.

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**Todd**: We invested in Praxair, which is now Linde, because we believe industrial gases will gain share in the economy as we decarbonize, cut energy and water usage, and develop new products using wind and solar energy. Linde offers a great place to work and their push to decarbonize is economically viable.

### How does ESG analysis relate to Parnassus's goal of finding high-quality companies?

**Todd**: Quality companies score well on measures of future relevancy to their customers, sustainable competitive advantages and effective governance. We think being good corporate citizens, setting the tone at the top, bringing in talent to help execute the vision of marketing, prioritizing product development, growing the business and pricing the product all help deliver better market positioning. By getting behind sustainable megatrends, innovating and establishing good

workplaces, management teams can build competitive companies that have good pricing power and potentially generate higher returns on capital than their competitors.

**Matt**: I would add that culture is an important aspect of good workplaces, and understanding the workplace helps us assess business quality. Good managers will take all of the diverse elements of their team and combine them to create and implement the most productive business plan for their unique circumstances.

## What is your experience with using an ESG framework to evaluate security risk?

**Matt**: At Parnassus, we engage companies to help them address potential risks to their businesses, and I think this is an area where we continue to differentiate our approach. An example is our engagement with Sysco. This company was one of the food distributors that had been unwittingly purchasing seafood caught with forced labor in Indonesia, which exposed their reputation with their customers and the community to significant risk. Sysco evaluated its supply chain, then eliminated 38% of the company's seafood suppliers because they did not meet its new supplier code of conduct. The company is now known for its leading supply chain monitoring practices.

ESG analysis can also help avoid key person risk, such as with sexual harassment claims, which are a legal liability for companies in an environment where executive conduct is under intensive scrutiny. It isn't realistic to screen out all ESG risk, but it's that comprehensive look at a business that helps mitigate risk across the board.

**Todd**: Part of the reason for assessing ESG risk is to help avoid tail risk and externalities that are almost black swan–like in that they are very difficult to predict by only looking at traditional business risk.

One area where tail risk can be very impactful is environmental practices. Another example is Wells Fargo, a major bank that is losing its social license to operate because of its unethical sales practices. Business ethics and practices can also be a tail risk for a drug company that's overpricing drugs or has product safety problems.

Assessing ESG risk involves looking at how companies treat their customers, how they deal with regulation, how they are addressing climate risk and how talent is nourished inside the organization. Risks in any of these areas can significantly impact the relevancy and value of the company.

I firmly believe that if a company is looking into the future, they're going to avoid what I see as the biggest risk, which is the risk of becoming obsolete. We're in the midst of the biggest disruption I've witnessed in 25 years of investing. Whether it's brick-and-mortar companies under attack, new business models, new ways of reaching customers or new ways of delivering product, almost every industry is experiencing massive disruption. Parnassus believes that the companies that rely on ESG principles to build talent and improve diversity are going to be the winners in the digital economy. So, while there are specific

risks that can be avoided, in a more general sense, companies that don't change when the economy is changing also pose a risk.

On the other hand, creating a positive ESG profile tees a company up to innovate, to have increased relevancy in the future and maintain a long-lasting moat. Companies like Clorox recognize this and work to achieve top-line diversity at the board level and sustainable product innovation.

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They use artificial intelligence to help them develop new products, and they outgrow their peers by 3% every year. Why? Because of their diversity, inclusion, innovation, knowledge of their customers, well-priced products, and reduction of their greenhouse gas emissions and carbon intensity. So really, ESG analysis seeks to avoid risks and find opportunities at the same time.

We think most investors today no longer believe that avoiding investments in poor ESG performers will hurt performance. On the contrary, many now see that the poorest ESG performers may be likely to pose the biggest risk to both portfolio performance and society.

## Can you find great companies using ESG analysis alone?

**Matt**: We start with fundamentals, and ESG is a mandatory component of the process, but ESG alone is not sufficient. The stock market highway is littered with all sorts of fantastic ESG companies that did not survive over the past 30 years.

## There is evidence that higher environmental scores in particular are now improving company performance. What's changed?

**Todd**: If the trend line of a company's carbon intensity is not going down today, the business will likely become a target of reform, regulation and carbon taxes. We believe reducing carbon intensity will be a megatrend going forward, and quite frankly, if a company is not looking to reduce its consumption of natural resources, including carbon, water and overall energy use, it's going to be at risk over the long term in a world of increasingly scarce resources. We want to see a narrow range of volatility in a company's income statement and balance sheet. If it remains primarily reliant on traditional energy sources instead of renewables, the company may be more likely to experience volatile profit streams and more volatile stock prices.

**Matt**: We believe companies need to improve their environmental profiles to be relevant in the future. The cost of having more sustainable operations in the near term is likely a lot lower than the long-term cost of cleaning up a future superfund site.

## In what ways do you think social issues help portfolio performance?

**Matt**: For each of the social components of ESG—workplace, community and customers—there are varying benefits across industries. Some of those benefits come from revenue generation and other

benefits come from cost reduction or margin improvement.

The workplace, as I mentioned before, is an important driver of company performance. Improving the workplace, making it a highly attractive place to be employed, should make employees happier and more productive, reduce employee turnover and, as a result, reduce expensive hiring costs. A motivated workforce with proper incentives is important in all industries, but the most significant issues vary. In the more physically demanding industries—utilities, industrials, energy businesses and materials, safety is very impactful for workplace morale and insurance costs. In the technology and financial services industries, great workplaces are a requirement for attracting the best talent and creating the opportunity to innovate.

**Todd**: I agree. There is so much value in a long-tenured, impassioned, diverse, well-compensated workforce. People will work harder and have more loyalty and pride in their work if they are treated well, so naturally the company will do better.

**Matt**: I recently read an article that explains why tech companies offer their employees such generous benefit packages. It turns out that strong benefits packages improve employee retention, and improved retention outweighs the cost of the benefits. It can cost a company as much as two times a tech worker's annual salary to hire and train a replacement.[2]

## How do you evaluate corporate governance from an ESG perspective?

**Matt:** We have two people on staff, Portfolio Manager Lori Keith and Director of ESG Research Iyassu Essayas, who are governance experts, and our reputation as a thought leader in ESG work, coupled with our large stakes in companies, gets us a seat at the table with company leaders.

Good governance is absolutely critical to the long-term success of a company. Speaking with board members at the different businesses to learn about the dynamics on the board is part of our investment process. We also want to understand the dynamics within senior management ranks. This kind of firsthand knowledge about the caliber of a company's leadership team provides invaluable insight into future prospects for the business, especially when it comes to ensuring that our goals and management's direction are aligned.

## What challenges remain for ESG investors today?

**Todd**: Now that more and more investment management firms are recognizing the value that ESG research can offer, investors need to look closely to understand the manager's overall investment approach. Is ESG an integral part of the manager's process, or is it an "add on" that is of minor importance to the strategy? Does the manager's ESG research integrate well with the rest of their investment approach? It's also important that investors ask themselves what problem they are solving. Some investors are passionate about a singular topic; others are interested in multiple issues. How important are returns? At Parnassus, we have a dual mandate of Principles *and* Performance®, which we believe has broad appeal, but each investor will have to decide for herself or himself.

## Do you believe ESG investing is here to stay?

**Matt**: Yes. Today, we see far greater awareness that

good environmental practices, good workplaces and well-incentivized management teams increase the quality of the firm. Investors and customers are also far more aware that their decisions can impact their lives and the lives of future generations. One reason for this is that previously unavailable and/or filtered information is now unfiltered and easily and quickly accessible. This dramatically increased transparency leads to greater community and shareholder scrutiny of companies and investment strategies, which is motivating corporations and investment firms to focus on ESG metrics. I'm especially proud to be part of Parnassus now, which has been an ESG leader since 1984. I believe the expertise and collective knowledge we have gathered and shared over the decades gives us a unique edge.

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To learn more, visit **www.parnassus.com** or call **(800) 999-3505**.

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[1] https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID18_0970/abcs_of_esg.pdf (accessed March 22, 2019) and https://www.morningstar.com/blog/2019/02/19/esg-landscape.html (accessed March 22, 2019).

[2] https://www.wsj.com/articles/techs-costly-health-benefits-pay-dividends-11551529980?mod=mhp (accessed March 22, 2019).

As of 04/30/19, Xylem Inc. represented 2.1% of the Parnassus Core Equity Fund's TNA, 3.7% of the Parnassus Mid Cap Fund's TNA and 1.2% of the Parnassus Fixed Income Fund's TNA (due 11/01/2026). Praxair Inc. represented 1.4% of the Parnassus Fixed Income Fund's TNA (due 01/30/2026). Linde PLC represented 4.7% of the Parnassus Core Equity Fund's TNA and 3.3% of the Parnassus Fund's TNA. Sysco Corp. represented 2.7% of the Parnassus Core Equity Fund's TNA, 2.6% of the Parnassus Mid Cap Fund's TNA, and 2.1% of Parnassus Fund's TNA. The Clorox Comp. represented 3.3% of the Parnassus Core Equity Fund's TNA, 2.7% of the Parnassus Mid Cap Fund's TNA and 1.2% of the Parnassus Fixed Income Fund's TNA (due 12/15/2024). Wells Fargo is not held in any of the Parnassus Funds.

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