Davenport Asset Management and the ESG Universe

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Executive Summary

ESG investing has grown in popularity and influence over the last decade, having reached a size and level of mind share that is impossible to ignore. We have done extensive research in recent years in an attempt to understand the merits of ESG integration and identify ways in which Davenport Asset Management can enhance its research process with its implementation. Throughout this journey, we have uncovered many inconsistencies and contradictions in the way ESG criteria are defined/implemented. Additionally, we consider ESG performance data to be insufficient, inconclusive and misleadingly marketed in many cases. All of this said, our research suggests that ESG does have the potential to create value as a part of a fundamental manager's risk management process. We therefore have devised a set of new reports, procedures and organizational enhancements that we believe will improve our research process. Importantly, we believe these updates integrate seamlessly into our current workflow and do not cause any undue distraction or sacrifice of our core values or discipline around fundamental bottoms-up research. Below, we sort through key industry dynamics, terminology, misconceptions and key findings of our research. We conclude with a summary of actions taken and processes adopted:

What is ESG?

ESG stands for environmental, social, and governance. Its purpose serves to offer a platform for companies to be evaluated in a non-financial manner. The image below shows a breakdown of each category and some of the topics that might be considered.

ENVIRONMENTAL

- Climate change
- Greenhouse Gas (GHG) emissions
- Resource depletion, including water
- Waste and pollution
- Deforestation

SOCIAL

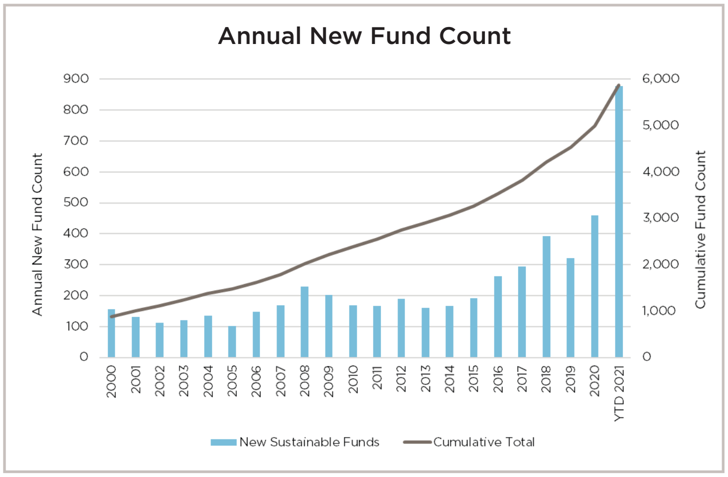
- Working conditions, including slavery and child labor
- Local communities, including indigenous communities
- Conflict regions
- Health and safety
- Employee relations and diversity

GOVERNANCE

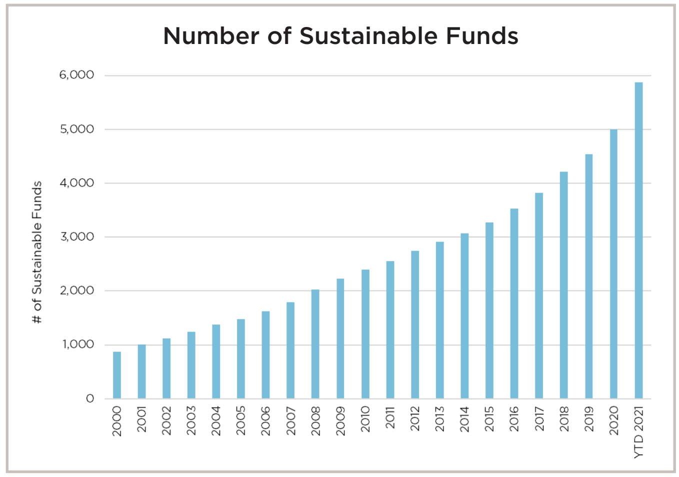
- Executive pay
- Bribery and corruption
- Political lobbying and donations
- Board diversity and structure
- Tax strategy

ESG Industry Overview:

Industry Size and Growth: As we will discuss in greater detail below, definitions of ESG investing can differ. Therefore, measuring the size of the market can be tricky. That said, it is undeniable that the industry has grown meaningfully over the last decade and is attracting more capital than it ever has before. The Global Sustainable Investment Alliance (GSIA) reports that sustainable investing Assets Under Management (AUM) globally grew from $13.6T in 2012 to $30.7T in 2018, a compound annual growth rate (CAGR) of 15%. The same report indicates sustainable investing AUM in the US grew from 1.4T in 2012 to 11.6T in 2018 (42% CAGR). As the charts below indicate, we have seen rapid growth in the number of ESG funds launched recently. While the majority of this growth has occurred in Europe where the practice is more mature, the US is seeing an acceleration as well.

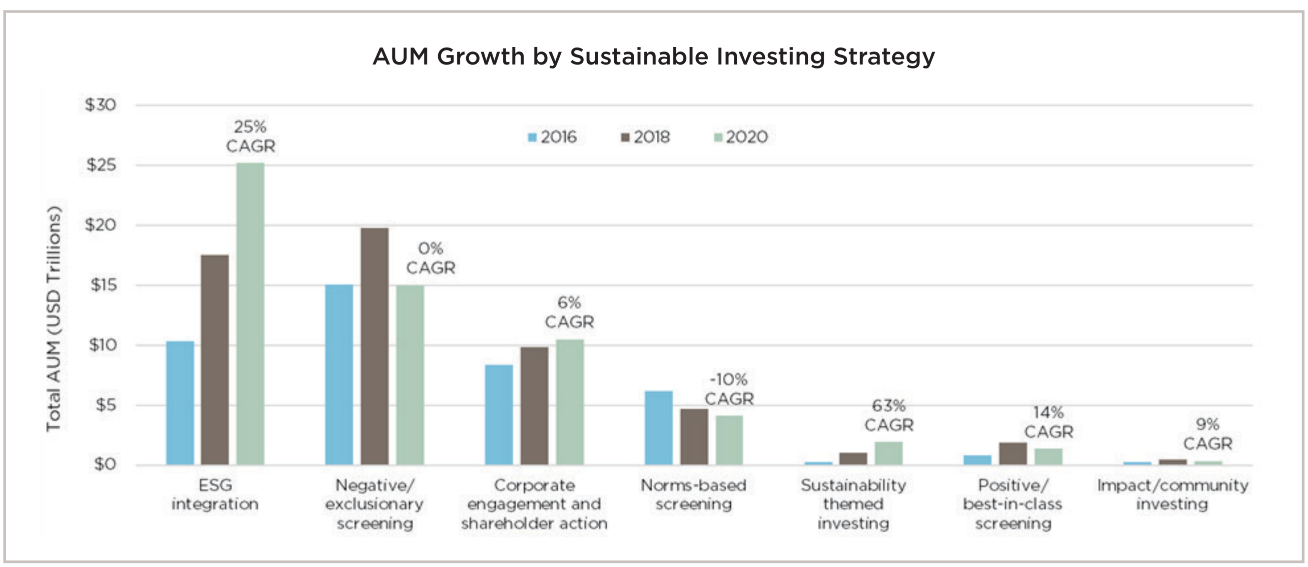


Source: Morningstar Direct



Source: Morningstar Direct

Methods of implementation: In many ways, ESG is commonly used as a catch-all term, which can refer to a spectrum of practices ranging from broader applications such as "exclusionary screening" and "ESG Integration" to "Sustainable" and/or "Impact" investing. As this chart below indicates, the broader applications contain the most AUM and are experiencing the most growth. According to Blackrock, ESG Integration is the practice of incorporating ESG information into investment decisions to help enhance risk-adjusted returns, regardless of whether a strategy has a sustainable mandate. This more flexible approach is what we have chosen to apply at Davenport Asset Management.



Source: Global Sustainable Investment Alliance - "Global Sustainable Investment Review 2020" Report

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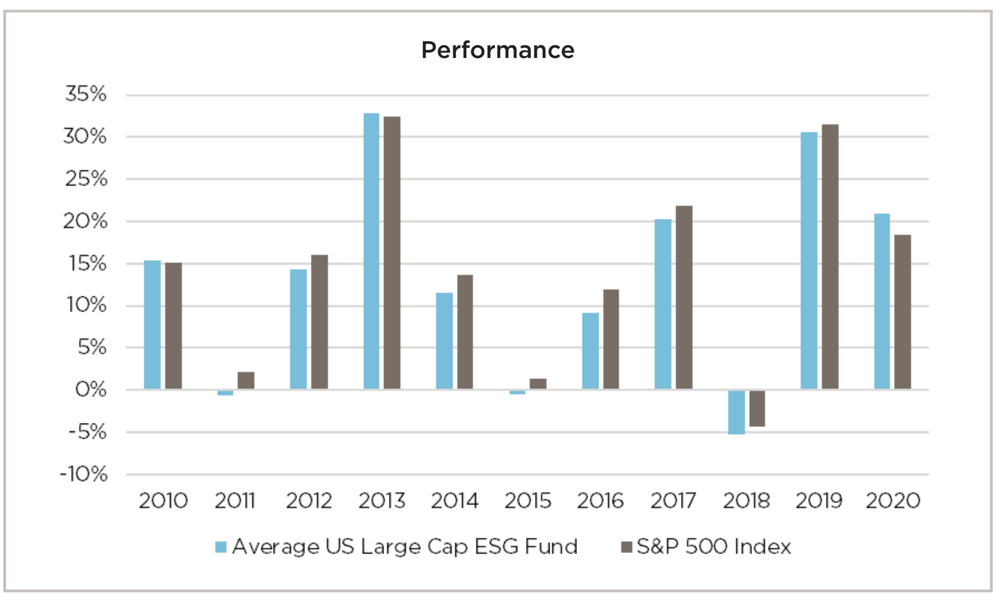
Below, we go into greater detail in terms of how some of these categories are defined and what their key differences are:

- **ESG:** ESG refers to the environmental, social, and governance practices of an investment that may have a material impact on the performance of that investment. The integration of ESG factors is used to enhance traditional financial analysis by identifying potential risks and opportunities beyond technical valuations. While there is an overlay of social consciousness, the main objective of ESG valuation remains financial performance.
- **SRI:** Socially responsible investing goes one step further than ESG by actively eliminating or selecting investments according to specific ethical guidelines. The underlying motive could be religion, personal values, or political beliefs. Unlike ESG analysis which shapes valuations, SRI uses ESG factors to apply negative or positive screens on the investment universe.
- **Impact Investing:** In impact or thematic investing, positive outcomes are of the utmost importance—meaning the investments need to have a positive impact in some way. So the objective of impact investing is to help a business or organization accomplish specific goals that are beneficial to society or the environment. Investing in a non-profit dedicated to the research and development of clean energy, regardless of whether success is guaranteed, is an example.

Inconsistencies and conflicting data – pitfalls of a programmatic approach: Though the premise of ESG is rather straightforward, the calculation of rankings and the interpretation of various risk factors is highly variable. At the end of the day, assessing ESG factors is a highly subjective process. Simply relying on ESG screening factors to arrive at portfolio construction is inappropriate. As such, we recommend a more "ESG Aware" approach, which enables us to understand various risk factors within the portfolio from a different angle while also maintaining the flexibility to ignore or override certain risk factors we believe to be of no concern

Performance: Below, we look at performance of the average Large Cap ESG strategy versus the S&P 500. As you can see, ESG in aggregate has its good and bad years. While there has been some data recently showing outperformance of ESG relative to other active managers, the jury is still out with respect to the ability of ESG to lead to outperformance over any meaningful amount of time. In fact, Morgan Stanley Institute for Sustainable Investing report analyzed the performance of ~11k mutual funds from 2004-2018 and found that the returns of sustainable funds were in line with comparable traditional funds over the whole period (i.e. there was no "consistent and statistically significant difference in total returns").



Source: Morningstar Direct

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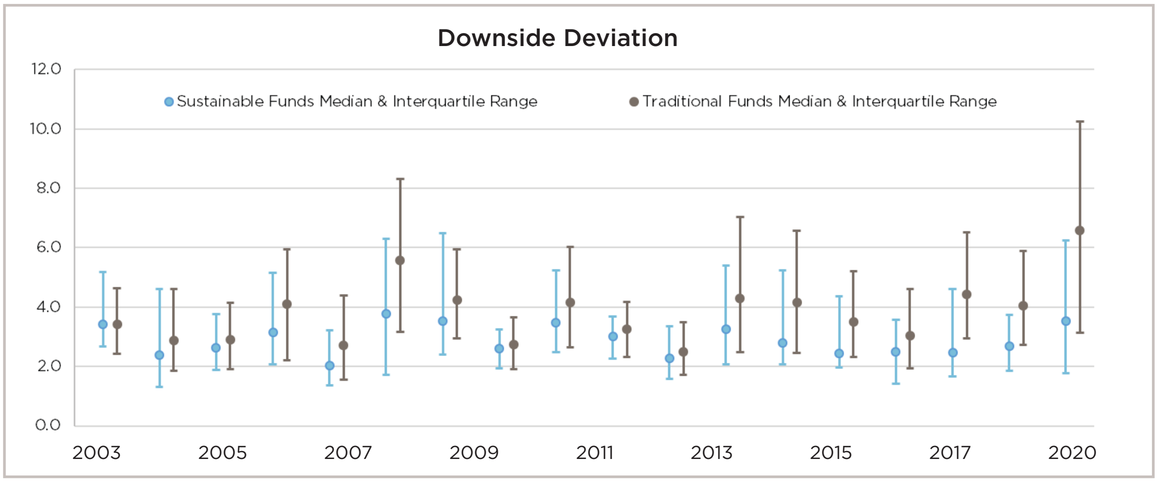
ESG and Risk: Whereas we are skeptical as to the degree to which ESG integration can lead to outperformance, there is more compelling evidence that it can lower the risk profile of a strategy. In fact, the same Morgan Stanley study referenced above indicated that Sustainable funds experienced 20% lower downside deviation than traditional funds. The chart below depicts this phenomenon.



Source: Morningstar Direct

DAM ESG integration: As we hope to have illustrated in the preceding overview, ESG is a rapidly growing investment theme that is gaining relevance in the investment community. From a big picture perspective, we believe intensified focus on these issues should continue to impact fund flows and the cost of capital for businesses looking to access public funds. Said differently, those businesses that can claim a higher degree of ESG compliance may likely see their cost of capital decline relative to peers, thus creating a competitive advantage. As such, we have incorporated the following updates to our investment process:

How We Incorporate ESG Factors into Our Research Process

Davenport Asset Management has a partnership with Sustainalytics, a Morningstar company and a global leader in ESG and Corporate Governance research and ratings. Our subscription gives us access to ESG Risk Ratings for the *Ratings+America Developed* universe (3,500 issuers) and *Global Large Cap* universe (approx. 4,000 issuers).

This platform allows us to enhance our research process in the following ways:

- **Reporting:** Portfolio and holdings specific reports that give us insight into the current (and historical) ESG ratings and risk factors
- **Discussion:** Recurring discussion of key ESG developments within our strategies
- **Idea Generation:** Incorporate ESG reports and analysis into the idea generation process

Our relationship with Sustainalytics should serve to augment an already robust research process focused on quality and risk. Though we do not believe an ESG filter is any sort of secret ingredient to investment success, we do believe that ESG integration can improve our risk management processes and enhance our overall research process by providing a different lens through which we can evaluate businesses and our portfolio.

The **Average US Large Cap ESG Funds** are actively managed US large cap mutual funds and ETFs that are designated as “Sustainable Investment – Overall”. Morningstar defines Sustainable Investment as a fund that explicitly indicates any kind of sustainability, impact, or ESG strategy in their prospectus or offering documents. “ESG Funds” incorporate environmental, social, and governance (ESG) principles into the investment process or engagement activities. “Impact Funds” seek to make a measurable impact with investments on specific issue areas like Gender Diversity or Community development alongside financial return. “Environmental Sector Funds” are non-diversified funds that invest in environmentally oriented industries like renewable energy or water.