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Corporate governance

Why activists are cheerleaders for corporate social responsibility

Profits, not ethics, are behind big-name investors' interest in ESG issues

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Think of shareholder activists and the word "ethical" might not be the first that springs to mind.

Yet among hedge funds, it is the activists who are paying most heed to environmental, social and governance concerns that were once the domain of Scandinavian pension funds and university endowments.

Funds including Trian Partners, Blue Harbour, Red Mountain Capital and ValueAct are all focusing on ESG as they seek to boost performance and as their own investors clamour for managers to show their commitment to ESG issues.

"It is hugely important for us, and we put it on the same scale as other things we look at — a company's cash flow, its market share, its management," said Cliff Robbins, the founder of Blue Harbour, an activist that focuses on small- to mid-cap companies. "Anything we can do to reduce risk is smart."

While Mr Robbins said that Blue Harbour was unlikely to invest in a company whose ESG profile was particularly poor — such as predatory lending or coal mining, for example — activists are not typically making a value judgment on which companies are ethical or unethical.

Instead, they are turning to ESG issues to mitigate risk and improve company performance.

Activist funds frequently hold positions for longer than typical equities hedge funds, and have concentrated portfolios to allow them to take significant stakes in the companies where they are pushing for performance-enhancing changes.

They say that improvements in board diversity, employee retention, environmental policies, supply chain ethics and data security and privacy — all common ESG concerns — can drive earnings and limit the risks of costly litigation or run-ins with regulators.

Brian Schorr, chief legal counsel at Trian, Nelson Peltz's activist fund, said the company did thorough due diligence checks on DuPont's environmental policies before taking a stake in the chemical giant.

"It was important to understand potential environmental risks and opportunities before we made the investment," Mr Schorr said. "We have a very concentrated portfolio and we wanted to be sure that if we invested, we had assessed what their existing litigation and environmental exposure was."

Will Mesdag, chief investment officer and founder of Red Mountain Capital, a Los Angeles-based activist fund that invests in small-cap companies, said he finds addressing ESG issues "rarely drives returns, but clearly reduces risk".

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> **Cliff Robbins, Blue Harbour**

"Good governance is essential," he said. "We always evaluate corporate governance and seek to improve it. The critical path is to enhance shareholder rights, tie executive compensation to performance, and refresh boards . . . At a minimum, a company must have an effective corporate social responsibility policy. This will translate into rigorous oversight of its supply chain and labour force as well as responsible behaviour from an ethical and legal perspective."

The issues for every company are different, said Mr Robbins.

"I think the most important thing for us is in the "s" of the ESG, in the social end of it, and what I mean by that is, how the companies feel about gender pay equality, what is the culture like, is there advancement for women and minorities? Does the management care about the health and wellness of their employees?" said Mr Robbins.

In one of Blue Harbour's more recent investments, in the health information website WebMD, the priorities were ensuring the company's data privacy and security were airtight, and advancing more women in the company. The majority of the website's users were female, he said, but women were still in the minority as employees.

Some research backs up a link between ESG concerns and higher returns. The Boston Consulting Group found that companies with more ethical operations make bigger profits and are valued more highly than competitors.

Activist fund managers said they were not necessarily looking for companies that already had good ESG policies in place because those that do often already have a strong share price and are unlikely to be the undervalued bargains sought by activists.

Hedge funds with non-activist strategies are also taking a greater look at ESG policies at companies in order to determine whether, and how, to invest.

Morphic Asset Management, an equities fund in Sydney, Australia, has begun doing "governance pairs trades" that include shorting the shares of companies it deems unethical.

Without divulging the names of the companies involved, Chad Slater, Morphic's joint chief investment officer, highlighted a recent trade involving Japanese builders. The fund invested in a condominium developer which Mr Slater said had a "progressive board", one with two members under age 40 and which had instigated a share buyback. Morphic also shorted a homebuilder he said had "terrible governance", a complicated ownership structure and a reluctance to pay out cash to shareholders.

In another example, the investment-grade credit group at Cheyne Capital, a UK-based hedge fund, analyses the role of governance and management in determining credit outcomes and has incorporated ESG scoring into its analysis.

Cheyne, which has an ESG fund — its Social Property Impact Fund, which funds housing for the disadvantaged that is leased at affordable rates — is also seeing increased interest from investors, especially those in Scandinavia.

Meanwhile, 60 per cent of investors say they plan to increase their allocations to responsible investments over the next three years, according to a survey by the consultancy Create-Research.

To activist hedge funds, that smells like an opportunity to attract more money to manage.

"I'd say we're at a tipping point where there's a lot more interest and concern," said Mr Robbins. "The endowments and universities [that invest with Blue Harbour] are interested because it's something their students feel strongly about; wealthy families who will be handing over their fortunes to millennials are interested; labour unions are interested; and state pension plans have really been pushing."