
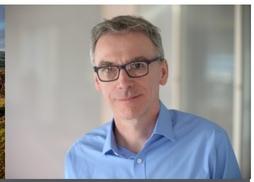

ESG Monthly Engagement

Fund Manager Commentary

Hugh Cuthbert | February 2022

INDEPENDENT THINKING

An Asset or a Cost?

Cop 26 and the pressing urgency of global warming has led to considerable focus on the E of ESG. However, the S and the attendant societal concerns should not be denigrated as a result and particularly where their importance to business and subsequently shareholder returns are concerned.

In a service economy such as the UK, where services represented 81% of output in 2020 (Source Economic Indicators, House of Commons Library, 12/21), people have become an all-important means of production and an increasingly core revenue generating asset for companies large and small. Yet this importance is not properly represented or recorded in a company's accounts. In certain circumstances, such as the transfer of a professional footballer, an upfront payment is made for the "asset" which in turn is recorded in the balance sheet of the company involved and depreciated over his or her useful life. More frequently an employee is simply considered to be an expense, not an asset, the same as a utility bill, a coffee cup, or a pencil. A strange way to treat what may well be the single source of income of the company concerned, be that a firm of solicitors, architects, a cleaning company or an IT services operation.

This not only makes the valuation of these "assets" more difficult for an investor than is the case for a company with more traditional tangible assets, but it also provides little to no insight on how well they are "maintained". If capex is running at or above the rate of depreciation for a building or an important piece of machinery, we have some confidence that those assets will continue to provide the output for which they are employed and can measure the return on that capital.

So, can we make the same calculations for the human element of a company and does this give us an insight into how long they may keep delivering the returns we would expect? In an ideal world the answer to this question would be yes, as there are certain factors and datasets that can allow for a realistic and fact-based analysis of a company's workforce. We need only look at the UN's Global Reporting Initiative (UN GRI) which provides recommendations for the best-in-class ESG reporting we should be asking from the companies in which we invest.

Image Source: Global Reporting[2]

The UN GRI standards are composed of 3 broad topics: economic, environmental, and social. From within these topics a reporting company can select the standards most material to their business model, resulting in a basic or *core* ESG standard of reporting or alternatively a more all-encompassing *comprehensive* level. Within the social topic grouping there are a multiple of standards applicable to the workforce at a level of detail only seen among the industry leaders in terms of ESG reporting and nearly always large corporations with both the time and resources to do so. For example, the standards include staff turnover by age, gender, and region. The UN GRI point out just how useful such data can be, in the following statement:

"A high rate of employee turnover can indicate levels of uncertainty and dissatisfaction among employees. It can also signal a fundamental change in the structure of an organization's core operations. An uneven pattern of turnover by age or gender can indicate incompatibility or potential inequity in the workplace. Turnover results in changes to the human and intellectual capital of the organization and can impact productivity. Turnover has direct cost implications either in terms of reduced payroll or greater expenses for the recruitment of employees."

Unfortunately, the UN GRI is not mandatory and so we lack the building blocks we require to make proper assessments of underlying value and indeed the welfare of the all-important asset that is people. But as the above example illustrates, there are both financial and altruistic benefits from analysis of this data both of which can clearly benefit shareholder returns.

[1] Economic Indicators – House of Commons Library - 30 December 2021 (parliament.uk)

[2] The Global Standards for Sustainability Reporting – Global Reporting - 2022 (globalreporting.org)

Featured Stocks

Tesco

We had cause to contact Tesco during December 2021 as reports emerged of further troubles in their wide and complex supply chain. The issue concerned a clothing supplier in the Indian state of Karnataka who had failed to pay the minimum wage to employees. Our correspondence requested an explanation of the circumstances and a reminder that we had previously requested greater clarity over supplier audits and the results of such actions. Tesco gave a long and detailed answer to our questions including the following statement:

"The key point is that we do not tolerate underpayment of wages, will ensure the wages are repaid and have written to our suppliers to this effect"

This appears to be a bold and forthright statement suggesting the situation will be resolved and at no stage did Tesco make any attempt to absolve their responsibility or deny the wrongdoing. Despite this, our intervention means we have a credible path to follow should the situation re-occur and escalation of the issue is required. We also hope that by expressing concern as shareholders we draw attention to the fact that in our considerations the welfare of supply workers not only represents a human rights issue but also one which could impact the value of our shareholding.