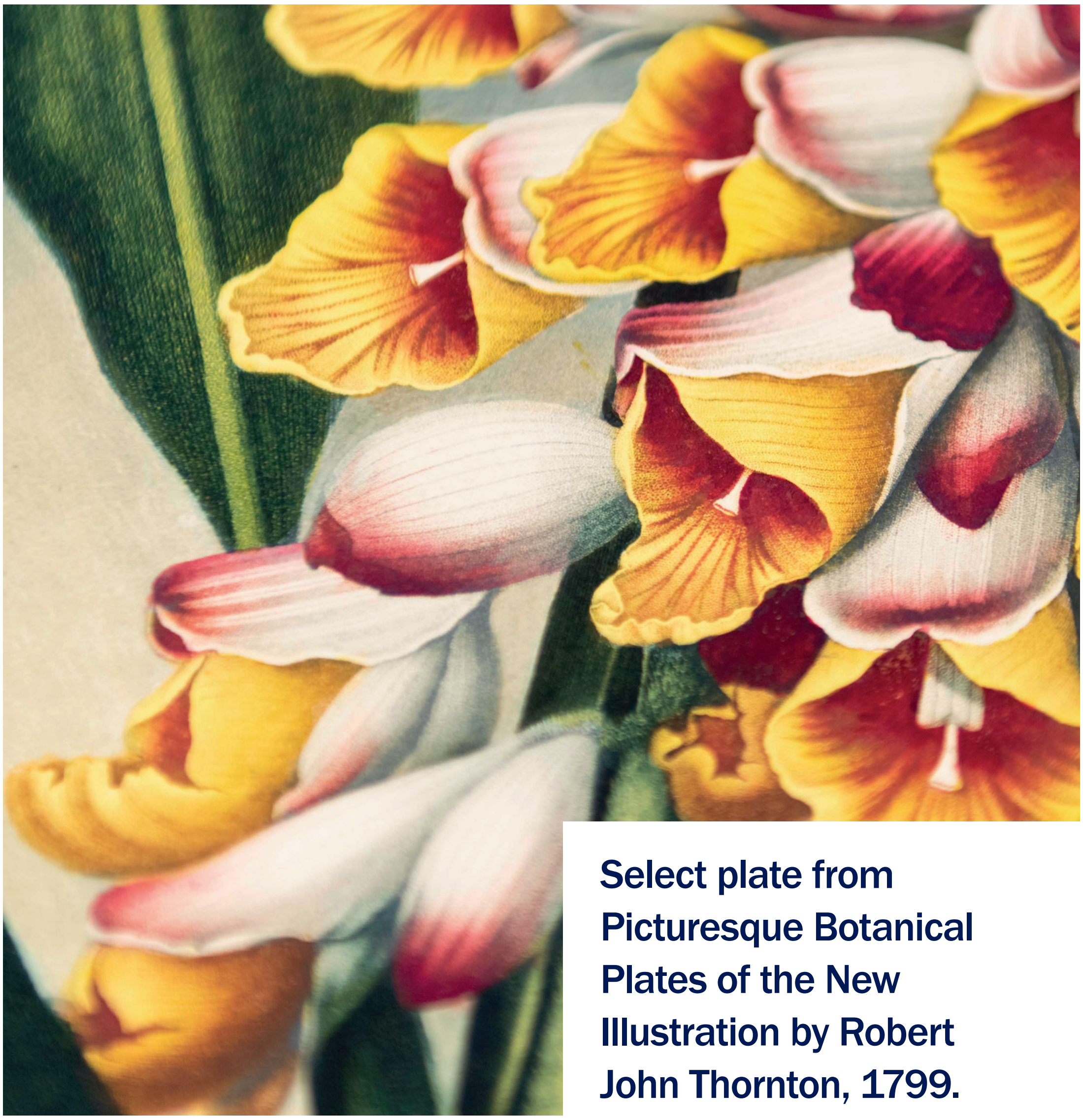
Sustainability goes mainstream

2019 ESG report

April 2020



Select plate from Picturesque Botanical Plates of the New Illustration by Robert John Thornton, 1799.

This large volume of illustrations was originally in the library of natural history works collected by Lionel Walter, 2nd Lord Rothschild.

The 2nd Lord Rothschild was a notable and passionate natural historian and scientist. In 1892, he opened a private museum that housed one of the largest natural history collections in the world. Still open to the public today, the museum is now part of the Natural History Museum in London.

Thanks to his lifelong contribution to the preservation of the natural world, hundreds of subspecies carry the Rothschild name, including insects, birds, mammals and fish.

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Foreword

Last year was the second warmest on record, and just 0.04ºC behind 2016, which was the warmest. Wildfires and floods around the world in 2019 highlighted the serious challenges we face as a result of environmental change.[1] In fact, the five hottest years ever recorded occurred between 2015 and 2019.[2]

There is no doubt that activists like Greta Thunberg and campaign groups like Extinction Rebellion have helped raise the public's consciousness about the urgency of global issues like climate change and poverty. This increased awareness is a major change from the past.

Another major change is the realisation that we all have the power and responsibility to do something about these global issues. Our everyday decisions affect society and the environment – from the food we eat to the clothes we wear to the way we choose to travel. As consumers, we're becoming more aware that our choices matter.

As professional investors, we know our investment decisions have an impact on the world around us. Increasingly, our clients want to know we're not just focusing on delivering financial returns, but also investing their money responsibly. We believe these objectives go hand-in-hand because responsible investing is consistent with our objectives to preserve and grow our clients' wealth over multiple generations.

We have a distinct investment philosophy and process, and in 2019 we continued to improve our approach to embedding responsible investment principles into our decision-making. As part of this ongoing commitment, we've recently published an updated responsible investment policy, which explains our approach to managing wealth.

We hope you enjoy reading this year's report, which highlights the progress we have made in 2019. We also explore some of our plans for 2020, and we'd welcome your thoughts and ideas as we seek to continuously improve our approach to investing responsibly.

Helen Watson
CEO, Wealth Management UK

[1] US National Oceanic and Atmospheric Administration, NASA

[2] World Meteorological Organization

Combining business and humanity

Our approach to responsible investing

Was 2019 the year when sustainability and responsible investing went mainstream? Not only did we witness an increased awareness of climate change, but we also saw a large shift in attitude by investors. For example, BlackRock's announcement that it would incorporate environmental, social and governance (ESG) factors in its active mandates was an important statement from one of the world's largest asset managers – and long overdue. The question for many investors has moved on from "should our wealth managers be doing this?" to "how are they doing this?".

The proportion of both retail and institutional investors that apply ESG principles to at least a quarter of their portfolios jumped from 48% in 2017 to 75% in 2019.[3] Although the idea of choosing investments based on your values has been around for decades, ESG investing has now become a regular part of the conversation.

The growing number of signatories to the UN-backed Principles for Responsible Investment (PRI) also demonstrates the increasing emphasis on investing responsibly. When the principles were launched in 2006, 63 investment companies with $6.5 trillion in assets under management (AUM) signed a commitment to incorporate ESG issues into their investment decisions. In 2019, the number of signatories grew to 2,372, representing $86.3 trillion in AUM.[4]

Mapping our progress

While investing responsibly has always been central to what we do, we are constantly looking for ways to improve how we integrate sustainability into our investment decisions. We believe we made significant progress in 2019.

At the beginning of the year we carried out a strategic review of our approach to ESG and responsible investing. We worked with an independent consultant to help us assess where we were – to recognise what we did well and where we could improve. We also wanted to understand what best practice looks like and explore how we are going to continue to incorporate these concepts into our investment process.

We've discovered that this process is an iterative one that involves formalising how we incorporate ESG into specific asset classes; testing and improving the process as we learn more; finding new and interesting themes in a continuously changing world; and formalising our approach as we adapt our process.

Following our review, we've worked on a number of projects during the year, which we believe have improved our investment processes.

One tangible output for our clients is our updated responsible investment policy, which we published in early 2020. We've called the new edition Investing in our future, and it offers an insight into our current thinking – how it has evolved, the practical steps we're already taking as responsible investors today and our vision for tomorrow.

Within the new edition of our responsible investment policy, we clarify for the first time areas we won't invest in, and those we believe require more stringent analysis in the decision-making process.

Companies are complex organisations and the impact of their activities is not always as it first appears. That's why we prefer to assess investment opportunities on a case-by-case basis, rather than applying broad exclusions. However, there are some fundamental principles we think all companies should adhere to and there are also certain activities we will avoid investing in – these are our 'red lines'. There are other industries where we acknowledge a greater level of scrutiny is required – we define these as 'amber zones'.

The European banker Siegmund Warburg wrote in 1926 of his summer working in the Rothschild family's offices in New Court, London:

"You provided me with many opportunities to learn. I learnt quite a lot of details of business machinery. But I learnt something also which will be far more important to me in my future life. This is the fine tradition of New Court which combines **business with humanity**, without neglecting either."

[3] *The ESG Global Survey 2019*, BNP Paribas

[4] *Annual Report 2019*, PRI

Red lines: We expect the companies we invest in to respect the United Nations Global Compact principles on human rights, the environment, corruption and labour practices. We will never knowingly invest in companies that breach these principles and would sell our shares if we discovered a company was doing so. We will also avoid investing in companies that are involved in armaments, gambling, thermal coal mining, coal power plants, pornography or tobacco.

Amber zones: There are other sectors and businesses where there may be questions from a long-term sustainability perspective While we don't exclude these activities outright, they fall into what we define as 'amber zones'. They require a greater level of scrutiny and analysis for us to understand their impact on society and the environment before we invest. Sectors that we consider to be in the amber zone today include alcohol, airlines, basic materials and fossil fuels.

Defining sustainable businesses

We firmly believe that investing responsibly is the only way to deliver attractive returns over multiple generations. It's an approach that involves taking a long-term view and investing in companies with sustainable business models and business practices, as well as selecting actively managed funds that share this philosophy.

Identifying sustainable investments is about more than just numbers. The process needs to consider a range of non-financial factors alongside more traditional financial metrics. In our view, sustainable businesses have the following important and interconnected attributes:

- They have strong business models, which means they are likely to sustain and grow their profits long into the future. These companies have strong competitive advantages, such as economies of scale, network effects or compelling intellectual property.
- They also have sustainable business practices that pay due regard to all stakeholders, and manage their ESG responsibilities well.

In 2018 we introduced the concept of 'materiality maps' for our investments, which help us focus on ESG issues that are financially material. In 2019 we embedded these maps in our investment process. They provide a framework for the sustainability issues we discuss with company management and our third-party managers, and they allow us to monitor progress.

Engaging with our third-party funds

We continue to encourage our third-party fund managers to formalise their approach to responsible investing. We are pleased to report that by the end of 2019 most of them had published a formal ESG policy. While we can't claim all the credit for this, we do believe our persistence in keeping this issue firmly on the agenda has contributed to this progress.

Three of our core managers – Ward Ferry, IVI and TCI – either published an ESG policy for the first time in 2019 or improved their existing policy. A further three managers – Cederberg, Lansdowne and Bares Capital – published statements about their commitment to ESG and responsible investing.

While there is still room for improvement, we're encouraged by the direction of travel. We'll continue to engage with our managers on this subject, challenging them about their ambitions, and looking closely at how they implement their policies and principles. In particular, we will be asking them to explain how they incorporate ESG factors into their research, decision-making and proxy voting processes.

We are pleased that more funds are exercising their proxy votes and reporting to us how they've voted. We're particularly interested when ESG factors have influenced their decisions, especially when they've voted against management recommendations. We'll continue to ensure that managers are open and transparent with us. If we find they've invested in companies we believe have ESG-related risks, we'll discuss our concerns with them confidentially.

Bares Capital

Over the past few years we have had a number of discussions with Bares Capital's founder Brian Bares and his team about how they implement responsible investing. We have actively encouraged them to formulate and publish a policy. During a two-day visit in October 2019 to the firm's offices in Austin, Texas, we were delighted to learn that Bares intends to publish an ESG policy and begin reporting on progress, and is working with ESG consultants to help them design and implement an internal framework to guide their research process. More recently, when we shared our updated responsible investment policy with them, they stated that they are "in total alignment" with our approach.

Fixed income

Over the past few years, we have formally integrated ESG considerations into our investment process for identifying and selecting equities and funds. Towards the end of 2019 we

Materiality matters: our assessment of key ESG factors for Moody's

Moody's is a credit rating agency whose core business is to provide credit ratings for debt issuers and analytics for fixed income investors.

Weak — Strong

Environmental

None

ESG data / green finance

- Integrating ESG risks, climate risks in particular, into its rating framework.
- ESG data, ratings and analytics, is a significant business opportunity. The company has made a number of acquisitions in this area.
- Well positioned to play an important part in the development of the green bond market.

Social

Customer incidents

Data privacy and security

Customer incidents

- Conflict of interest – clients pay for ratings.
- Corporate ratings have been in line with actual default statistics for many years. Lowering the quality of ratings due to client pressure would impact their reputation and credibility.
- Issue with ratings during the global financial crisis was mostly confined to securitised debt (such as sub-prime)
- Settlement with the US Department of Justice in 2017 for $864 million.

Data privacy and security

- Access to material non-public information of clients.
- Strong processes to mitigate the threat from cyber attacks.

Governance

ESG integration and oversight

Business ethics

ESG integration and oversight

- Integrating ESG factors into credit ratings provides opportunities.
- Expanded its ESG offering recently.

Business ethics

- Potential abuse of pricing power.
- Operates in an oligopolistic industry, so we monitor culture, behaviour and management comments about this.

Mitigating factors

Risks

created an integrated process for fixed income securities, and in 2020 we will be putting the new process to work and make adjustments as we go along.

In general, the fixed income market has seen less ESG integration than other asset classes. However, appetite is growing as investors increasingly appreciate that ESG factors can and do affect the value of bonds.

We know that our process of applying a sustainable approach when investing in bonds is a different exercise than when we invest in equities. It makes sense to diversify exposure in portfolios across a large number of debt issuers, which in turn requires a more systematic approach to integrating ESG factors.

Our premise for investing in bonds is the same as it is for direct equities. We assess each issuer against the principles of the UN Global Compact, and we draw the same red lines. We then use risk ratings provided by Sustainalytics to identify companies with weak ESG practices (see box 'Research partners'). Following our own fundamental analysis of these risk factors, we then decide whether to exclude certain issuers from our investment universe.

The Exbury Fund: a sustainable investment approach

Towards the end of 2018, we launched the Exbury Fund. While we manage all our client assets responsibly, the Exbury strategy intentionally moves further along the spectrum of responsible investment strategies (figure 1). The Exbury strategy is an extension of our core responsible approach and is 'sustainable' as well as responsible. The strategy has a two-fold objective of 'avoiding harm' and 'actively contributing' to social or environmental good.

The Exbury Fund extends our approach to investing responsibly by aligning its investment strategy with the Paris Agreement and UN Sustainable Development Goals. The process involves not only identifying economic activities that are inconsistent with the goals, but specifically targeting economic activities that are actively contributing or adapting to the Paris 2050 objectives.

Based on this framework, we've defined three categories for companies that are:

- inconsistent with the international goals;
- neutral, not inconsistent nor actively contributing to the goals; and
- enabling.

We've made good progress in evolving the Exbury strategy. Towards the end of 2019, we started to reposition the portfolio towards businesses that are actively contributing or adapting to the Paris 2050 goals, which we call 'enablers'. Initially we are setting a minimum 30% exposure threshold to enablers, but we aim this weighting to increase on an annual basis.

Our research partner

We acknowledge that we don't know everything, and since 2018 we have used ESG-focused research provided by Sustainalytics to complement and challenge our own research. This partnership continued in 2019. Sustainalytics' qualitative research acts as a form of sense check to our own research and can also help us identify any blind spots.

Sustainalytics evolved its processes in 2019 by incorporating risk ratings in its offering. This new methodology identifies the key material risks to a business and assesses whether management is addressing these risks appropriately. As such, it is more aligned with our own focus on materiality. We commend Sustainalytics for assessing ESG factors through this different lens, which is better suited to our investment process than an ESG rating.

Figure 1: The spectrum of responsible investing, from traditional to philanthropy

The following five categories are widely recognised as the main ways to invest.

	Traditional	Responsible	Sustainable	Impact	Philanthropy
Financial goals	Maximise financial returns for shareholders	Maximise financial returns for investors	Maximise financial returns for investors	Seek financial returns for investors + Measurable non-financial impact	No measurable financial return + Measurable non-financial impact
ESG objectives	ESG-agnostic	Exclude harmful activities	Exclude harmful activities	Balancing financial return with quantifiable social or environmental impact on stakeholders	Donating to address social or environmental issues
		Screen for ESG risks	Screen for ESG risks		
			Seek positive ESG impact		

Source: Rothschild & Co, based on the Bridges Spectrum of Capital

Engaging and voting

In our view, engagement is one of the most powerful tools we have to influence positive change

We take a proactive approach to selecting and monitoring investments. An important part of our investment process is getting away from our desks and meeting people in order to build our knowledge and relationships. Over the last year, we spent a great deal of time with businesses and experts in related fields, where we were open to sharing best practices or identifying possible investments.

As active owners of our investments, we can influence the ways companies and fund managers manage their ESG risks and opportunities. If we can encourage them to operate more sustainably, not only will this lead to better investment outcomes but will ultimately create more positive outcomes for society and the environment.

In this way we believe it's possible to create a 'ripple effect'. Our investment approach, combined with the reputation of our firm, give us a very powerful voice when it comes to encouraging positive change. When we are managing your wealth, your voice becomes part of the £10 billion we are investing. This in turn has a ripple effect on the £3 trillion of total capital represented by the companies and funds in which we invest.

We view engagement as an ongoing conversation, and we believe we can exert influence and make a difference. Given our relationships with the businesses and funds we invest in, in combination with our research-driven approach, if we encounter any new material ESG issues or concerns, we will engage with that business first. In the case of significant concerns, we might divest.

We recognise that no company is perfect. Just as we are on our own journey with regards to sustainability, many companies are also on a journey of improvement or change. As and when concerns do arise, we engage directly with management.

Below we have included some examples of the ways we have engaged with companies and fund managers over the past year.

Admiral: climate change

We have invested in UK insurance company Admiral since 2015, and we're one of the largest shareholders. We have regular contact and speak to the chairman of the board every year about corporate governance. Two years ago, Admiral revamped its executive compensation scheme and incorporated a number of our recommendations. Since then, we've continued to have constructive conversations with the board about how the company can better align executive compensation with driving long-term shareholder returns.

In 2019 we also spoke to Admiral about a complaint filed against them by Client Earth, an environmental law charity, regarding climate change disclosures. While we were aware the

Participation in industry initiatives

We believe it's important to keep up to date with the latest developments in responsible investment and think the best way to do so is to meet and network with other investors and experts in this field.

We support and participate in a number of industry initiatives in order to develop and share best practice in responsible investing. Some of the highlights from 2019 include:

PRI in Person in Paris: In September, members of the investment team participated in this conference, which is one of the major events in the calendar to learn about the latest developments in the industry and to meet with like-minded professionals to share best practices. Having been PRI signatories since 2018, this is the second year we have attended this conference.

CFA (Chartered Financial Analysts) UK annual ESG Conference: The conference focused on the practicalities of ESG integration across the financial industry, and also included discussions on client expectations, engagement and policy initiatives.

Global Impact Investing Network (GIIN) Investor Forum: While we are not currently active in the impact investing arena, this conference was of interest as many of the topics discussed were relevant to responsible investing.

Financial Conduct Authority (FCA) had reviewed the complaint and decided not to pursue it, we wanted to understand what had happened.

After our conversation, we were satisfied with how the company had resolved the issue with both the FCA and Client Earth. Climate change is one of several risks Admiral, as an insurance company, has to manage, and we will continue to monitor this issue closely. What is encouraging is that Admiral has decided to report more fully on the risks of climate change, which is very much in keeping with the progress we want the companies we invest in to make.

Middleby: remuneration

Middleby manufactures commercial food service equipment and has acquired many other companies as part of its long-term growth strategy. When companies acquire other businesses, we believe it's important they have the right incentive structure in place for managers to focus on creating long-term shareholder value.

We believed the way in which Middleby compensated its senior management team was too focused on short-term performance. While many of the senior managers have a large portion of their own wealth invested in Middleby's shares, implicitly giving them an incentive to focus on the company's longer term success, we still had concerns.

In 2019, Middleby changed its compensation scheme, so that the award for – and the vesting of – certain shares is now partially tied to its three-year cumulative performance. While we are encouraged by this development, we're continuing to discuss ways the company can further improve the link between executive pay and company performance with Middleby's chief executive officer and chief financial officer.

In the case of acquisitive companies like Middleby, we believe incentives should be linked to measures that take into account the profitability on capital invested. The board and directors have acknowledged our suggestions and indicated that the compensation structure can evolve. We will continue to monitor developments closely.

Proxy voting

We believe voting is a key part of managing our clients' assets responsibly. We always exercise our votes and believe this is part of our duty to our clients.

Our investment team reviews all resolutions before shareholder meetings and we only decide how to vote after due consideration and discussion. Generally speaking, our focus on high-quality businesses with appropriate corporate governance structures means we do not expect to vote against the recommendations of a board in many cases in any given year. However, we will do so if we believe it is in the best interests of our clients.

Figure 2: Managing wealth responsibly

We voted against the recommendations of Charter Communications' board on two resolutions in 2019.

Resolution 1 **Shareholder proposal to allow the nomination of directors by shareholders**	**Resolution 2** **Shareholder proposal that the company produces an annual sustainability report**
We voted in favour of a shareholder proposal – which wasn't supported by the board – to allow the nomination of directors by shareholders that have owned at least 3% of the company's shares for at least three years. We decided these were appropriate hurdles for nominating board members.	Charter Communications is one of the few companies in our portfolios that does not publish data about its carbon consumption. Given our increasing interest in data of this nature when assessing the risks and opportunities facing a business, we voted in favour of greater disclosure. Proxy advisors including Institutional Shareholder Services (ISS) and Glass Lewis also recommended shareholders support the proposal. We will also be supporting the Carbon Disclosure Project's efforts in pushing for greater disclosure.

Source: Rothschild & Co

Figure 3: 2019 proxy voting record

Of the total 144 votes we cast in 2019, we voted against the board's recommendation in two instances.

	For the board recommendation	Against the board recommendation	Abstained	Total
Board of directors				
Election of directors	66	–	–	66
Director stock ownership	1	–	–	1
Compensation				
Advisory vote on executive compensation	11	–	–	11
Advisory vote on frequency of compensation votes	1	–	–	1
Incentive plan	4	–	–	4
Remuneration policy	–	–	–	–
Remuneration report	3	–	–	3
Capital structure				
Allotment of securities	7	–	–	7
Changes to authorised capital	–	–	–	–
Changes to bonds, warrants and or conditional capital	–	–	–	–
Corporate structure	–	–	–	–
Disapplication of pre-emption rights	7	–	–	7
Dividend declaration	1	–	–	1
Payment of dividend	1	–	–	1
Repurchase of shares	4	–	–	4
Strategic				
Political donations	2	–	–	2
Financial reporting				
Receipt of financial statements	3	–	–	3
Audit related				
Ratification of auditor	14	–	–	14
Remuneration of auditor	4	–	–	4
Administrative				
Amendments to articles	–	–	–	–
General meetings	2	–	–	2
Stockholder proposal	11	2	–	13
Total	**142**	**2**	**–**	**144**

Source: Rothschild & Co

Looking forward

In a complex and constantly evolving world, we don't pretend to have all the answers. While investing responsibly has always been central to what we do, this is an ongoing journey and we're constantly striving to improve how we integrate sustainability into our investment process in order to make better-informed investment decisions.

The Financial Reporting Council released a new version of the UK Stewardship Code at the start of 2020, which is now more demanding. Following the progress we made in 2019 with regard to our processes and on the back of our updated responsible investment policy, we are well prepared to meet these higher standards. We are updating our engagement policy, which also includes a detailed section on our proxy voting practices.

Climate change and the associated risks are becoming more pertinent, and companies need to improve their efforts to address these challenges and be more transparent about what they are doing. In 2020, our aim is to engage with all our company holdings about a common reporting standard on climate risk. We believe the Task Force on Climate Related Disclosure (TCFD) is setting the right standard and will be supporting these efforts through our engagement.

What is the Task Force on Climate Related Disclosure (TCFD)?

The TCFD will develop voluntary, consistent climate-related financial risk disclosures for use by companies when providing information to investors, lenders, insurers and other stakeholders.

The Task Force will consider the physical, liability and transition risks associated with climate change and what constitutes effective financial disclosures across industries. It will help companies understand what financial markets want from disclosure in order to measure and respond to climate change risks, and encourage firms to align their disclosures with the needs of investors.

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

Holdings mentioned in this report are not shown as a solicitation, recommendation or promotion of any security or fund on a standalone basis. Holdings are subject to change without notice.