The Upside

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Announcer: Hello and welcome to Fidelity Connects, the Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

Flows into ESG-focused products were at a record high in the U.S. last year as more and more investors look to align their investments with their values. Today, we'll look at recent trends and what the future of sustainable investing looks like.

Host Emily Anonuevo speaks with Nicole Connolly, portfolio manager and head of ESG investing, and Courtney Bedell, ESG analyst. Nicole shares that there were $50 billion of flows into ESG products in 2020, double the amount of 2019. Also, the Global Clean Energy Index had a strong run after President Biden's win, but the Index has underperformed lately. But Nicole believes we're in the early innings of a massive market share shift from fossil fuels to renewable energy.

In addition to the record flows in 2020, additional themes Nicole and Courtney unpack are how companies are treating their employees during COVID and a return to work, as well as cybersecurity. You may ask yourself what does cybersecurity have to do with ESG? Nicole will let you know. They also discuss Fidelity's in-house ESG ratings system for companies, and Nicole shares a bit about her fund, Fidelity Women's Leadership Fund and the recent growth of women in positions of leadership in companies.

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Emily Anonuevo: Recent studies show investors are serious about sustainable investing and are investing in companies that are taking a real stance on socially and environmentally conscious issues. In fact, ESG flows were at a record high in the U.S. alone last year, and many assets are managed according to sustainable mandates. ESG, which stands for Environmental, Social and Governance, is becoming a key criteria to how companies do business. It's clear investors are turning their attention to ESG. So, what does the future look like for sustainable investing? And what recent ESG theme should investors be aware of? Today, we'll take a deep dive into this topic with our expert panel, portfolio manager Nicole Connolly and ESG analyst Courtney Bedell. Welcome to you both. So happy you can join me in this discussion today.

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Nicole Connolly: Hi Emily, it's great to be here and excited to be here with my team-mate Courtney.

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Courtney Bedell: Thanks for having us.

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Emily Anonuevo: Absolutely. Looking forward to our conversation. Nicole, I'm going to turn it to you first. Before we jump into this topic, can you just briefly remind investors on the line about your fund, the Women's Leadership Fund, and what it focuses on and how ESG influences your portfolio as well?

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Nicole Connolly: The fund, which is two years old this month, we launched in Canada two years ago. It's really a fund that invests in companies that are paving the way for future female leaders and really prioritizing gender diversity. I think what's unique about this fund is that we do all the traditional analysis, fundamental analysis that a traditional fund manager would do in assessing the financial outlook for a company, but we also do a deep dive into about 25 different diversity and inclusion criteria which really helps us get a sense of the culture and the innovation at the company. I believe if those things are done well, companies that do those things well, will outperform over the long term.

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Emily Anonuevo: Great overview. I know diversity, inclusion and like you said, gender diversity, all part of the ESG umbrella. Courtney, if I could turn it to you, you are an ESG analyst with the ESG team, obviously. You've described them as a small but nimble group. What does your role involve exactly? What does your research mainly focus on?

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Courtney Bedell: Absolutely. I'll just take a minute and maybe give an overview of our team. Our team really tackles ESG investing by sector. We have analysts covering health care to consumers to financials and technology, and we spend our time building expertise on companies and key issues that are pertinent to those sectors. For me personally, I cover the energy, industrials, and material sectors. I spend a lot of time reading the companies within those sectors on ESG. I also spend a fair amount of time developing expertise on environmental areas of focus, particularly carbon emissions, as well as climate change, generally. Additionally, I also help with shareholder proposals and how we think about that on the environmental and social side.

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Nicole Connolly: And Emily, when she's not busy doing all those things, she's also getting her degree in Sustainability at Boston University. So she's a real valuable asset for us.

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Emily Anonuevo: That's amazing. I was going to say so much on your plate, Courtney. And I just love the opportunity that both of you are on the show today because I've spoken to you both on separate occasions, but this is the first time we're all together talking about just this incredible topic. So much to cover and we'll try our best in the next half an hour. Nicole, I want to turn it to you and just talk about 2020, obviously a huge year for so many reasons. But on the ESG front, so much focus on climate change, race issues, social themes. Do you feel like this year, 2021, the same themes are playing out or are there different ones you're tracking this year?

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Nicole Connolly: It's a great question. Just to put some numbers around what you said, Emily, we saw 50 billion of flows into ESG products in 2020 which was double the number that we saw in 2019. So far, year-to-date flows into ESG funds in the U.S. are double the amount of what we saw 2020 year-to-date, so continuing that trend of acceleration. I think just for the reasons that you mentioned, urgency around climate change, social justice movement and then the pandemic, really having investors think about how their investments are aligned with companies that are treating their employees well and keeping them safe and healthy. This year, in terms of themes, there's a whole bunch of different themes.

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I would talk about maybe two now which are: what does return to work look like and how are companies going to bring back their employees? This is kind of playing out real time with Apple employees, just writing a letter to Tim Cook earlier this week, upset about having to come back to the office three days a week versus other tech peers like Facebook and Twitter have said you can basically work anywhere. So, it'll be really interesting to see how this plays out. I think your approach to work from home, it can potentially dictate your ability to attract and retain talent is theme number one.

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And then a second theme is actually cybersecurity. You might ask what does cybersecurity have to do with ESG? But one of the things that ESG analysis allows us to do is look at externalities or risks that a company faces that might not be readily observable today but that, if faced, could really undo the company immediately. And cybersecurity is definitely one of those risks. We're seeing this play out a couple different ways. You have these cyber threats from nation-state actors or hacking groups that are affiliated with the/a country. The SolarWind's breach and the Microsoft server breach were examples of those kind of cyber threats where these hacking groups are trying to get insights into computer infrastructure across the United States.

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Then you also have these more like ransomware attacks, which are hacking groups that are getting into the systems of restaurants and pipelines. We saw a 9-1-1 dispatch system broken into and then demanding some kind of ransom to get the system up and running. This is scary, right? This is happening now across all different sectors. We really think it's creating a do-it-for-you type of service where there are companies, cybersecurity companies that are going to help retailers and energy companies that don't have the expertise to do this work themselves. And so we're excited about some of these cybersecurity stocks and really researching cyber as part of the ESG mosaic.

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Emily Anonuevo: That's fascinating, never even thought about it that way. I guess that would even fall underneath the G letter, the corporate governance.

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Nicole Connolly: Yeah, it's so funny. It's like it is G, but it's also when we think about the social and protecting our customers and protecting customers' data, it's also, I think, woven into the S as well.

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Emily Anonuevo: You're absolutely right about that. Really, really interesting, especially like you said, as we now move into a different phase of this new normal. Some people are going to be still continuing to work from home and then others slowly going back into the office. It's just so much to look at this year. Courtney, if I could turn it to you and if you can elaborate on some of the research you're doing right now and how companies are adjusting to their mandates to include more ESG goals specifically this year.

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Courtney Bedell: Great question, really excited to talk about this. I'll just quickly highlight a few areas of research I've been focused on and excited about. One is on sustainable aviation. What I've been really focused on doing is just gaining a baseline understanding of what the viable options are for decarbonization in this really challenging sector and really understanding the nitty gritty challenges behind that. Not only whether it's viable for us to have hydrogen planes in the future, but also just how are we going to fuel that in an airport. So there's things that we really have to think about across the value chain when we're thinking about this. I really like thinking about that and helping guide investment decisions around the energy transition.

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One other area that I'd highlight quickly is just the role of oil and gas in the energy transition. I know this is really a hot-button issue, but I think carbon capture and direct air capture are really interesting aspects in this sector and seems to be a real focus for U.S. integrated oil companies, especially. Vicki Hollub, CEO of Occidental, for example, one of her major goals for Occidental is to be the first carbon management company in the world. I think that's just a stunning announcement from a major oil and gas company. Economics here are still really challenging but oil and gas companies have this kind of expertise already. They've been using enhanced oil recovery which is injecting carbon into the ground in order to extract oil and I think this really gives them a leg up in terms of helping with the transition and something that's important to think about.

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Emily Anonuevo: That is so interesting, especially with the aviation and the emerging technologies there. The research you do sounds so fascinating and learning so much already. Nicole, can you expand on that and just elaborate on new conversations you might be having with companies this year on the ESG impact and all these different themes Courtney just mentioned? Just interested to know what you're discussing with these companies?

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Nicole Connolly: I think the clean energy sector is really interesting here. The S&P Global Clean Energy Index has underperformed the S&P by about 30% year-to-date. That's due to rising yields and really, the sector had run so much after the Biden win and all the investments that are going to happen into clean energy. I think it's a really attractive opportunity now and valuations have been reset. We are just in the early innings of a massive market share shift from fossil fuels to renewable energy. But like Courtney said, fossil fuels are going to be part of the solution to get to a low-carbon economy, so trying to find the ones that are investing in renewables and are doing everything they can to reduce the carbon footprint of their existing operations is something that we're focused on.

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In terms of your question about what are we talking to companies about? We just talked to a health care company that I own in the fund about product safety. We're able to get access to the head of quality and product at this company and that's the kind of access we get at Fidelity. So, we were really able to dig into some product recalls that had happened over the past five years and just really get comfortable that there is a focus on quality, that it's in the company's key performance indicators, that they're getting compensated on this. That's the thing ESG, every company has different material ESG factors. So you're not necessarily asking the same ESG question to each company. So we just focus on, okay, what's material for this company and let's zero in on that topic.

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Emily Anonuevo: That's interesting that you mentioned that the key questions you're asking companies and how they're aligning their mandates with ESG. Is there a strategy you follow, a formula or is it case by case, company by company?

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Nicole Connolly: It's case by case and Courtney, maybe you would talk about some of the materiality factors in energy as an example.

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Courtney Bedell: I think that this is a really good question. I might just walk through my strategy quickly when I approach an engagement with an energy company. I think the most important thing is to focus on, like Nicole said, materiality. What that means might vary depending on the company. So I think I try to match where I think there's areas to improve on for a particular energy company, and that's usually carbon emissions. So often my calls are structured where we'll spend maybe three-quarters of the call on carbon emissions to really try to dig out whether there's a real strategy there. I'm not sure if this is really answering the question well, but I think it's kind of tying in both what's really financially material and then where we see the company falling behind peers or where we think they could make a bigger impact and sometimes where we think we could learn from a leader. So I think those are some of the priorities when we structure engagements

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Nicole Connolly: Maybe just another example, I'll really just try to bring this home for people, is we were talking to a large-cap tech company who's had issues with employees walking out over harassment issues and equal pay for equal work. They're now talking about tying ESG metrics to their compensation, which I think is great, but we were really digging in with the company to say which metrics. The company has done so much on the environmental side, we didn't want to just see environmental metrics get tied to compensation when it seems like the social piece is where the company needs to do some work. So we were just sharing our feedback that it would really be great if, as part of these ESG metrics tied to compensation, that the social piece was one of those metrics.

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Emily Anonuevo: That absolutely answers the questions. I just wanted to dig in more into the thought process and the criteria that you're posing to these companies. It is really interesting to get into that perspective. Nicole, if I can just stick with you and talk about this broad perception about sustainable investing that it means sacrificing returns. Why is there that misconception and what should investors be aware of when it comes to this issue?

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Nicole Connolly: Maybe just a couple of pieces of research that we've done or been a part of. When we look at high ESG scoring companies over the past seven years, we see that those companies outperform the market by about 1 1/4% every year in each of those seven years, and that's adjusting for any sector bias. We've also been working with Goldman on looking at ESG controversies. So taking 25 controversies over the past 10 years and looking at things like product safety, data privacy controversies, oil spills, and have found that not only does the stock perform in the one year following the announcement of the controversy but in the three years, these companies are underperforming their sector peers by 39%.

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So it just speaks to kind of the downside protection that can be found in applying an ESG lens. Then we also see it on diversity and inclusion. When we looked at 10 years of data of companies that had above-average diversity in the management team, we found that those companies also outperformed by about 1% a year over the last 10 years. This really builds on what was already a pretty solid foundation of empirical evidence that suggests that ESG can be additive to performance. I think we're only just going to see this type of research grow.

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Emily Anonuevo: Those are amazing numbers and facts to back it up. I'm going to expound on that in a minute but I wanted to bring in this live question from one viewer. They're just asking to expand on some more trends you're seeing in the environment and climate leadership landscape. Throw it to you, Nicole or back to Courtney.

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Nicole Connolly: So, yes, another one would be offshore wind. We just talked with one of the largest offshore wind developers out of Europe. Offshore wind makes up less than 1% of the renewable energy landscape. We just think that this is another trend within renewable energy that is here to stay. I would say that the cost curves for all of these technologies have been coming down dramatically. So we're seeing these companies be more profitable. We're seeing them being more cost competitive with traditional fossil fuels, so would highlight offshore wind, onshore wind, solar. Maybe Courtney, if you wanted to hit hydrogen, if you had any thoughts there. That's a more nascent technology with still a lot of ways to go to get to be economic. But I don't know, any thoughts there, Courtney?

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Courtney Bedell: I might just take it out a little bit high level and talk about the IEA net-zero scenario that came out a few weeks ago and has really, I think, gotten a lot of attention just because of the aggressiveness that we really need to pursue some of these technologies and exit, I think, in some ways some of the traditional energy sources that we've used. Hydrogen definitely plays a huge role in this net-zero scenario and I really think that we've had analysts do some great work within Fidelity on where hydrogen is promising and what solutions exactly it will be used for. I think that sometimes it's seen as a silver bullet. I have a feeling it's going to be a bit more complicated than that, even with just aviation. I think most aircraft manufacturers are not quite as excited as I think we'd hoped they would be about this and see it maybe in a slightly more limited capacity. But I would say that just the big trend would just be the aggressiveness that we really need to switch how we're investing from traditional fossil fuels towards new technologies and renewable energy to hit some of those net-zero milestones.

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Nicole Connolly: Emily, I was just looking at some of the questions and I think one thing that may be helpful to talk about is just the ESG ratings that we do in-house. Somebody asked about just how much of our work is outsourced versus what we do in-house. One thing that we're really excited about that we just want to make sure everybody is aware of is that we just rolled out ESG ratings across all of our holdings and across a decent chunk of benchmarks that we run against. These ESG ratings were done both by the ESG team and the fundamental analysts and again, focusing on those material ESG factors and coming up with both what the ESG outlook looks like today, which is our systematic rating, and then what it looks like going forward, which is our forward-looking fundamental ESG rating. So there's a combination of quantitative and qualitative inputs into that. But we believe we're really one of the only asset managers out there with a really thoughtful, rigorous ESG ratings framework.

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Emily Anonuevo: Perfect. You just answered that second viewer question perfectly. There's another one specifically for you, Nicole. One viewer was asking, how much growth has there been in the inclusion of women in positions of leadership in companies? You mentioned off the top of the show, the Women's Leadership Fund had been running for two years in Canada. What can you say in terms of inclusion of women in those positions?

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Nicole Connolly: Yeah, it's a good question. I think we've seen board gender diversity improve pretty dramatically over the past 10 years. I would say female CEO representation is still, it's 5% of the S&P is led by women. I like to say if the S&P looked like more like my fund, we'd have 150 more female CEOs in the S&P. So, I think we still have a long way to go, so that's why I'm very passionate about this fund and the impact that this fund can have.

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Emily Anonuevo: Absolutely. We can talk another half an hour on this topic, I hope we get another opportunity to do so. I want to thank you so much for this great discussion. I know our investors on the line appreciate you sharing all this valuable information and your insights as well so thank you for being here.

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Nicole Connolly: Thanks, Emily.

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Courtney Bedell: Thank you.

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