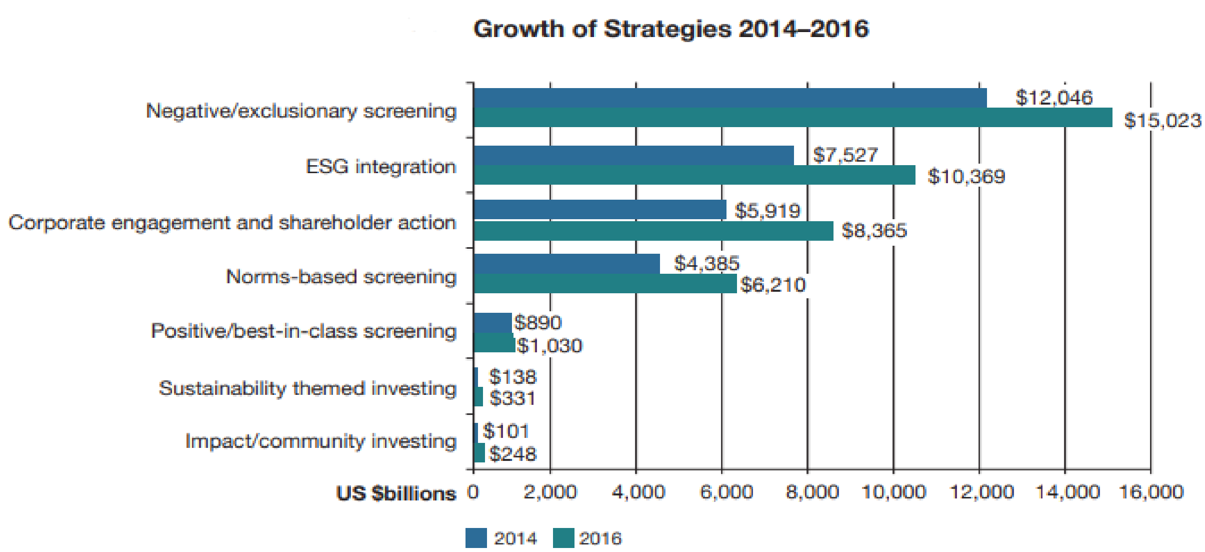
CHALLENGES OF ESG INTEGRATION

Increasing Demand for Fundamental Analysis Integration

Increasing demand by parties interested in Environmental, Social and Governance (ESG) products has grown the landscape around sustainability and ESG funds. Evolution of this trend started with Socially Responsible Investing (SRI) and negative/avoidance screening. Advancement continues with the integration of ESG considerations in how companies operate and increased disclosure of material risk factors. Lastly, a further extension of this effort comes in the form of Impact Investing, which aligns to a core belief, theme or motif.

The recent growth of United Nations-supported Principles of Responsible Investment (PRI) signatory assets under management (AUM) has been staggering, with annual AUM increases of ~30% and signatories jumping 200% over the past four years. It should be noted that assets fall into three distinct categories: SRI, ESG Integration, and Impact Investing. Chart 1 below shows the growth within certain categories. The largest category globally is SRI, or negative/exclusionary screening ($15.02 trillion), followed by ESG integration ($10.37 trillion), and corporate engagement/shareholder action is the third-largest category ($8.37 trillion).[1] Since we utilize both ESG integration and Active Engagement in our process, we group those two areas together.

Chart 1



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<u>Responsible Investing Categories</u>

SRI is probably best known as negative screening or avoidance screening, i.e., certain groups of stocks are restricted from investment. Default constituents within this category are the "sin stocks" (Gambling, Alcohol, Tobacco, Weapons, etc.). Faith-based organizations have most frequently employed this strategy, given that these restrictions typically align best with their values. As noted in the Chart 1, SRI remains the largest category and, with the increased use of divestment as a tactic (e.g., Fossil Fuel Free), will continue to grow. While SRI methodology provides a distinct and effective way to distance a portfolio from certain segments of the market, applying negative screening or excluding parts of the market from an investable universe will, by default, increase risk and tracking error. Managers should be aware that industry cycles can lead to underperformance when an excluded group outperforms. For example, Alcohol and Tobacco can see increased demand during recessionary time periods. Conversely, a percentage of cruise line revenue is derived from gambling and might thus be excluded in an Ex.-Gambling strategy. Such an exclusion could prove a detractor when increased consumer confidence leads to increased discretionary spending.

The PRI defines ESG Integration as "the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions." There are four stages of the integration: Qualitative Analysis, Quantitative Analysis, Investment Decision, and Active Ownership Assessment, and at each step in the process, the ESG risks and material factors are weighed and integrated into the valuation case. The intent is to evaluate the ESG risks and apply a discount or premium to its valuation, based on those variable and material factors. This type of analysis requires experience and knowledge of the variables that affect that segment of the market and or globe, ESG Integration incorporates all the available information affecting a company and views it within the context of the company's operational and business segments. This is generally the best representation of how ESG should be considered for a long-term shareholder to create value.

Impact Investing is the effort to construct a portfolio specifically to impact or support a positive social or environmental theme (Clean Water, Ending Poverty, Better Education, etc.), whereby the investment can have the most "impact." Most often these impacts are aligned or associated with the UN Sustainable Development Goals (SDGs). Focusing the investment toward a specific theme can be more meaningful, but also has the potential for unintended consequences, such as high correlation between investments in the same sub-industry.[2] Further, by investing in a theme or a motif, the manager is inherently forced into a narrow universe of investable stocks. With the increased usage of the UN SDGs, this group should also increase.

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Areas of current investor interest are shown in Chart 2 below.[3]

Chart 2

Barrow Hanley ESG Approach

Barrow, Hanley, Mewhinney & Strauss, LLC (BHMS) is a signatory of the PRI and the Investor Stewardship Group (ISG). Our approach to responsible investing is underpinned by the BHMS Guiding Principles for Responsible Investing, and the key elements of the PRI and ISG. We have managed socially-responsible mandates for more than 30 years, and more recently employing ESG factors in our stock analyses and in the construction of equity and fixed income portfolios. We currently manage more than $5 billion in SRI-related assets across all strategies. While client values will dictate the strategy and alignment to the appropriate responsible investment category, we believe that the consideration of ESG factors in our investment process is commensurate with the pursuit of superior risk-adjusted returns for our clients and their beneficiaries. This approach to investing makes sound business sense and, as an advocate for our clients and for the long-term futures of their beneficiaries, we believe it is the right thing to do. Consequently, the ESG integration approach aligns with our investment process as value investors and the opportunity to partner with the management teams provides a unique advantage to work toward long-term returns and ESG risk considerations.

We continue to invest heavily in third-party ESG research, which we believe increases our awareness of potential ESG factors that should be included in an investment process due diligence. However, while availing ourselves of different providers' opinions has given us a much broader understanding of the public information available regarding our companies, we may not always rely on the findings. For instance, third-party ESG research providers have an extensive universe but there is often a 6 to 12 month lag before new information is updated in research. Our unique approach of meetings and communication with companies' managements allows us to stay ahead of that information delay.

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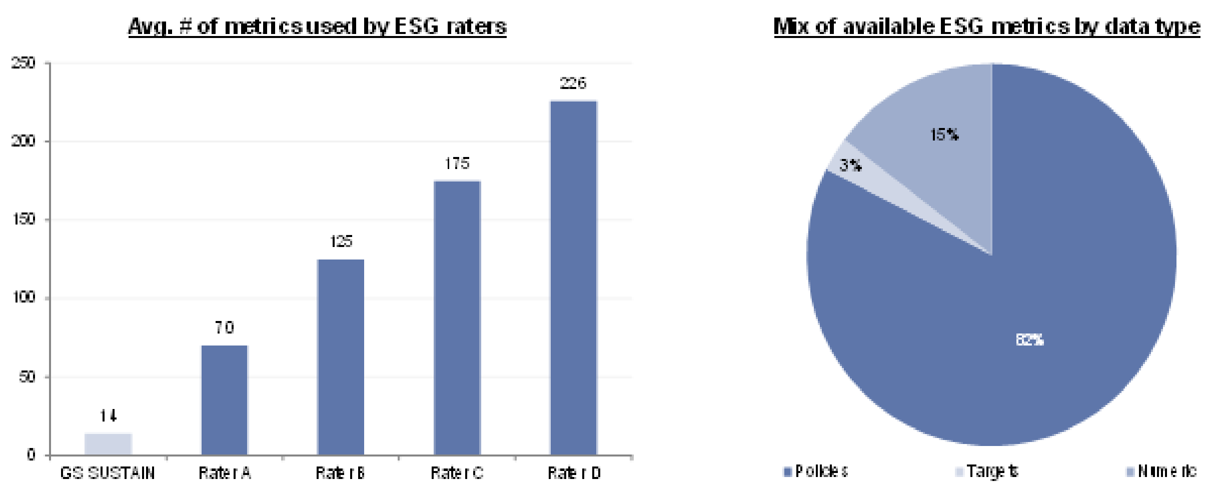
Additionally, there can be biases in the research; i.e., one provider may concentrate mainly on megatrends or thematic issues while another may focus on disclosure and transparency. Using the Russell 3000 constituents, we have found a low correlation (less than 0.4) between the ESG scores of third-party providers. Coverage is another issue; 5% to 20% of that same index constituents may be unrated. This is frustrating for companies trying to be more transparent and for investors seeking to leverage the information. Despite these factors, we continue to look at all the research to which we subscribe.[4]

BHMS' team of investment professionals is uniquely stable, turnover is limited, and the average years of experience and firm tenure are 22 and 10, respectively. This depth allows us to leverage the history and relevant experience within and across sectors to distinguish what is material and useful for integration into fundamental analyses. Historically, we have been able to integrate many different pieces of research into the mosaic of a company's investment and our approach relies heavily on our investment professional's assignments of individual ESG pillar scores for each idea initiated. Those scores are then joined to a proprietary weighting of third party data to round out the company's overall score, then tilted toward better-disclosing companies. We find that this last step speaks to our process and offers an opportunity to influence management teams to be more transparent. Chart 3 from Goldman Sachs shows how difficult it can be to manage the providers, from either a supplier (company) or consumer (investor) perspective.

Chart 3



Left Chart: Average number of metrics in widely used 3rd-party ESG scoring frameworks; Right Chart: Mix of available ESG metrics by data type

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Our position as the second-largest active value-oriented equity manager in the U.S.[5] provides us direct access to senior management, further enhancing our ability to address and analyze relevant ESG factors. As a top-25 shareholder in more than 160 companies, we can encourage company management to consider the sustainability of company assets, improve the awareness of ESG issues, help effect meaningful changes, and forcefully advocate for our clients. We are by no means activists, but we remain active with the executive teams and boards of our companies, participating in ~700 calls or meetings per year – this means that, on average, we speak with company managements at least four times per year. Such frequent communication allows us to ask targeted and thoughtful questions, and fosters better understanding of the information companies have provided through their standard disclosures. It also helps us build long-term partnerships with the companies, unlike activists that often have less constructive dialogues. Further, unlike investors with a shorter time horizon, our investment process involves a ~3 to 5 year holding period, as we believe that positive and lasting value creation takes time.

Conclusion:

Barrow Hanley has strengthened our investment process by integrating ESG and we are committed to the growth and evolution of our proprietary approach. As a thought leader in our industry, we are well-prepared to affect positive change on behalf of our clients. As we work with our clients and management teams, we strive to ensure that our process and philosophy incorporates material ESG issues in our fundamental valuation work and active engagement with management. Further, we continue to work and partner with leading external organizations, including local universities and international committees, to refine our best practices. Effective ESG integration requires a patient, long time horizon and low turnover; and Barrow Hanley's more than 30 years of value investing have provided well suited responsible and profitable stewardship of our client's assets. We would like the opportunity to partner with you as you look for defined ESG strategies and integrated ESG approaches.

Footnotes:

1 https://www.ussif.org/files/Publications/GSIA_Review2016.pdf.

2 http://www.fortunefinancialadvisors.com/blog/examining-industry-return-correlations.

3 https://www.ussif.org/files/Infographics/Institutional%20Investor%20in%20PDF.pdf.

4 https://library.sasb.org/engagement-guide/.

5 *Pensions & Investments* May 29, 2017, based on U.S. institutional, tax-exempt assets as of December 31, 2016.

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About Barrow, Hanley, Mewhinney & Strauss, LLC

Founded in 1979 in Dallas, Texas, Barrow, Hanley, Mewhinney & Strauss, LLC (BHMS) is a Delaware limited liability company and SEC-registered investment adviser. BHMS is considered one of the most respected value-oriented asset managers in the country, providing investment strategies to institutional investors, mutual funds, and family offices. Barrow Hanley has been managing long duration bond portfolios for corporate pensions for more than 28 years. As of December 31, 2017, the firm had $91.7 billion in assets under management. To learn more, visit www.barrowhanley.com.