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Investing with a Best-in-Progress Approach

The future may lie in recognizing companies advancing sustainability even before they achieve "best-in-class" status.

SUSTAINABLE INVESTING

KEY TAKEAWAYS

- We believe sustainability-minded investors should look beyond traditional sustainability leaders to "best-in-progress" companies making substantial strides toward a greener future.
- A best-in-progress approach can provide three key benefits: (1) the ability to drive real-world outcomes, (2) the potential to generate alpha, and (3) the opportunity to eliminate the inherent style biases found in traditional sustainable investing approaches.
- We've developed a framework to identify best-in-progress companies and integrated it into our time-tested value process to create a new solution for sustainability-minded investors: Global Sustainable Value.

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According to one school of thought, investing with a mind toward sustainability means systematically buying stocks with the best sustainability attributes, which often excludes entire industries from consideration.

Based on this approach, a sustainable investor might gravitate toward technology and telecommunications stocks with small environmental impacts while shunning carbon- and water-intensive industries such as utilities, energy, mining, materials and agriculture. This approach — sometimes called best-in-class — can be seen as penalizing companies in brown industries by shifting capital away from them and lowering the cost of capital for green industries.

The impact of this cost of capital-driven approach is debatable.[1] In one recent study, the authors find that reducing the cost of capital for green firms leads to small improvements in environmental impact. In contrast, increasing financing costs for brown firms leads to large negative changes in impact for those firms. In other words, directing capital away from brown firms and toward green firms may be counterproductive as it makes brown firms browner without making green firms greener.

At the risk of oversimplifying the researchers' thesis, they point out that for the goal of reducing greenhouse gas (GHG) emissions, sustainability leaders — defined as companies whose carbon intensity is low — have little room for improvement. Conversely, brown companies with a high emission intensity have much greater opportunities to move the needle in terms of meaningful emission reductions.

Among other findings, the study shows brown firms react to financial distress (measured by interest coverage, Altman Z-scores and poor industry performance) by increasing emissions, while green firms show a much smaller response, sometimes in the opposite direction.[2]

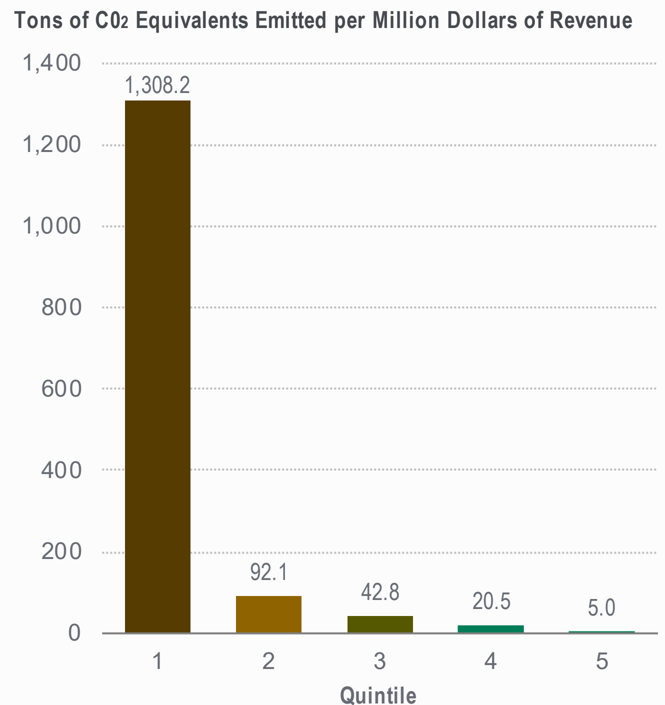
We believe divesting from or avoiding these companies that are automatically perceived to be less sustainable overlooks a compelling opportunity. The chance to invest in companies taking meaningful steps toward greater sustainability—an approach known as best-in-progress investing— can potentially drive tangible real-world outcomes and offer an enhanced alpha proposition.

Why is that? One argument is that any enhanced alpha that best-in-class companies could have offered has been squeezed out by ESG funds that formulaically direct more capital into those stocks.

Notably, avoiding companies that are not best-in-class in terms of sustainability overlooks the potential for active ownership and engagement to drive sustainability-related advances in their business models.

We use GHG emissions as an example. As shown in Figure 1, nearly all GHG emissions generated by publicly traded companies have come from the worst performers — even the second-worst quintile is not remotely as bad as the bottom (brown) quintile.

FIGURE 1
Brown Quintile Offers Greater Opportunity for Improvement



Data from 2000 – 2020. Source: Samuel M. Hartzmark and Kelly Shue, "Counterproductive Sustainable Investing: The Impact Elasticity of Brown and Green Firms," November 1, 2022. Available at SSRN.

This shows that for investors to drive tangible reductions in GHG emissions, we must push incumbents toward a greener future.

How can we do that? As active managers, we believe the most effective approach to shaping corporate behavior is to own a stock and constructively engage with the company's management team.

[1] For: Chava (2014), van der Beck (2021), Kacperczyk and Pedro (2022), Pastor et. Al (2022), Green and Vallee (2022). Against: Teoh et al (1999), Berk and van Binsbergen (2021). Irrelevant due to impact elasticities: Hartzmark and Shue (2022).

[2] Samuel M. Hartzmark and Kelly Shue, "Counterproductive Sustainable Investing: The Impact Elasticity of Brown and Green Firms," November 1, 2022. Available at SSRN.

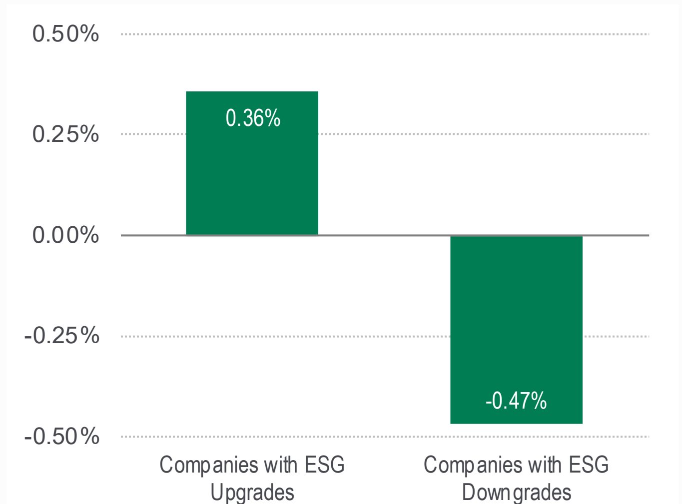
Importantly, if direct engagement does not have the desired result, we can use our proxy voting power to influence corporate behavior. To state the obvious, that power is available only to shareholders — not those on the sidelines. Thus, we believe active ownership of brown incumbents is the most effective way to drive real-world outcomes regarding reducing GHG emissions.[3]

Further, we believe a best-in-progress approach can potentially advance our alpha proposition. It's no secret that sustainable investing has been heavily politicized in certain parts of the world. However, we have found a unifying viewpoint across our client base regardless of geographic location: *More sustainable businesses are more valuable.* Thus, if we can invest in companies that are improving the sustainability of their businesses in an economically rational manner, we can share in the financial benefits created as they make this transition.

American Century's Global Analytics team conducted an exhaustive study analyzing changes in external ESG ratings and the subsequent relative performance of upgraded versus downgraded stocks. As Figure 2 shows, companies with upgraded ESG ratings outperformed relevant indices, while those whose ESG ratings were downgraded lagged.

FIGURE 2
ESG Upgrades Have Led to Excess Returns

Average 12-Month Excess Return After ESG Rerating (MSCI World Value Index)



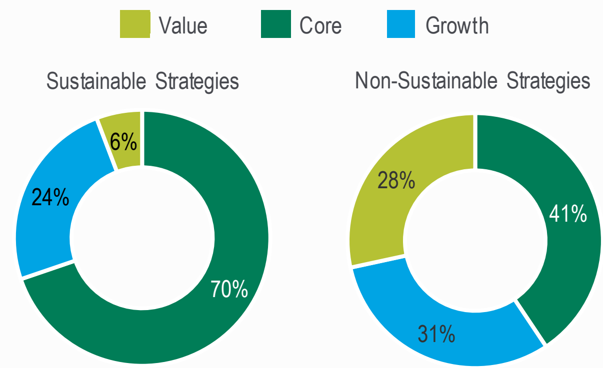
Data from 1/1/2007 – 3/31/2023. Source: American Century Investments, FactSet.

Does a best-in-progress strategy offer any other benefits? Absolutely. We have witnessed significant growth in the sustainable investment landscape over the last decade, which, according to Morningstar, now comprises over $2.7 trillion in assets as of June 2023.

Due to inherent style biases associated with best-in-class and other traditional forms of sustainable investing, 94% of sustainable institutional public equity assets reside in either the growth or core styles (see Figure 3).

FIGURE 3
Institutions Have Low Exposure to Sustainable Value Equities

Distribution of Institutional Assets by Style as of 6/30/2023



Data as of 6/30/2023. Source: eVestment.

This can lead to large bouts of underperformance for sustainable investors' public equity allocations, as witnessed in 2022 when the growth investment style significantly underperformed. A best-in-progress approach is highly congruent with the value investment style. It can be paired with, or even replace, more traditional approaches to sustainable investing to eliminate style biases that often arise in sustainable investors' public equity positions.

Consistent with this line of thinking, another study, "Applying Economics – Not Gut Feel – To ESG," argues that because the sustainability issues that society faces are so urgent, pressure to show a commitment to strong ESG practices can lead to actions or statements based on a gut feeling rather than careful analysis. The study's author describes identifying value through sustainable investing as both "extremely important and nothing special," saying it is no different than identifying value in other intangible assets that create long-term financial and social benefits.[4]

[3] It is worth noting that many green patents are held by brown incumbents because large industrial companies often have big research staffs to develop new patentable approaches. They also have the resources to acquire small, innovative companies with patents they have not monetized. Thus, many incumbents are well-positioned to benefit from the shift toward a greener world economy, but their valuations may not reflect the potential their patents represent.

[4] Alex Edmans, "Applying Economics – Not Gut Feel – To ESG," *Financial Analysts Journal* (forthcoming), August 22, 2023. Available at SSRN.

FINDING SUSTAINABLE VALUE

American Century's Global Value team has long kept a keen eye on best-in-progress companies pursuing greater sustainability, either through their operations or by developing products that help other companies realize their sustainability goals. The team recently created the Global Sustainable Value (GSV) portfolio comprising roughly 60 companies that have demonstrated a commitment to improving sustainability.

While the portfolio is new, the thinking behind it is not. For the last 30 years, the Global Value team has generated alpha by scouring the globe for high-quality businesses that trade at a discount to what we believe is their actual value. We have delivered strong risk-adjusted returns for decades by combining quality with a value-driven perspective and are now expanding this concept by explicitly recognizing its connection to best-in-progress sustainable investing.

Starting in 2016, we have incorporated sustainable research into our fundamental investment analyses because we realize that doing so increases our risk awareness and, in certain industries, improves our financial models. Our sustainability risk assessment includes the following:

- A macro-level analysis that identifies sustainability issues that may have long-term effects on a company due to market shifts or evolving regulatory standards.
- An analysis of ESG issues that could affect competitive forces and profitability within a specific sector.
- A materiality perspective that examines how these issues may affect a company's financial performance and risk management.

Our engagement activities with management teams have also increased, exceeding 200 in 2022.

And, with sustainable research deeply embedded into the process, we have developed proprietary tools that form the backbone of the Global Sustainable Value portfolio.

Improvement Pathway

The GSV portfolio reflects and is true to our quality-value roots. Every holding comes from the same proprietary universe of roughly 575 high-quality companies we use to construct our other value-driven strategies.

We look for companies with a well-established "Improvement Pathway" for consideration within the Global Sustainable Value portfolio. Companies that have embarked on an Improvement Pathway display one or more of the following characteristics:

1. **A commitment to sustainability.** These companies do not just talk about sustainability. They commit resources to operational improvements and make capital expenditures that result in tangible, sustainable outcomes. We should be able to see this in their products and services, and how they run their businesses to contribute to a more sustainable future for the company and society.
2. **Operational improvements.** A company's progress toward sustainability may not show up in current data, perhaps because a previous management team disregarded sustainability or because it just recently committed to this effort. Companies in this category have embarked on a journey to operational improvement that many analysts have not yet recognized.
3. **Attractively valued sustainability leaders.** These sustainability leaders are still improving, but their valuations do not give them credit for their leadership in this arena. We do not seek to invest in overvalued best-in-class "darlings" because we are value investors, but we buy sustainability leaders when the market doesn't recognize that leadership position.
4. **Sustainability enablers.** These companies develop products and services that help other businesses or consumers achieve sustainability. Examples range from products other companies use to reduce their GHG emissions to a service or innovation that allows employees to improve workplace safety. By enabling sustainability for others, these companies realize greater earnings potential within their own operations.

Key Performance Indicators

We evaluate a company's Improvement Pathway using key performance indicators (KPIs) for each industry in our investable universe, which allows us to track a company's progression over time. We highlight a few KPIs from each economic sector in the following table.

SECTOR	QUANTITATIVE KPIs	QUALITATIVE KPIs
COMMUNICATION SERVICES	Broadband/internet expansion capital expenditures	Network social benefits (enabling sensor adoption and automation)
	# of data protection processes and certifications	Executive compensation structure
	% independent directors	Board refreshment
CONSUMER DISCRETIONARY	% of volumes/sales from EVs or EV supplies	Supply chain audits and oversight
	Absolute levels of wages and wage growth relative to industry	Lawsuits/controversies per employee
	Emissions and water intensity	Climate targets
CONSUMER STAPLES	% recyclable/reusable packaging content	Supply chain audits and oversight
	Penetration levels of healthy/healthier product offerings	Product circularity initiatives
	# of or % improvement in supply chain certifications	Green bond issuance
ENERGY	GHG emissions intensity	Executive compensation structure
	% of volumes from low-carbon energy production/services	Board refreshment
	# of or % improvement in safety/incident rates	Medium-term climate targets
FINANCIALS	Capital drawdowns under severely adverse scenarios - stress test	Cybersecurity oversight
	Liquidity coverage ratios	Executive compensation structure
	Credit charge-off rates	Community Reinvestment Act rating and changes
HEALTH CARE	Emerging market sales growth %	Improving health outcomes in emerging markets
	# of or % improvement in FDA warning letters	Improving processes/controls or eliminating the sale of hazardous products
	# of or % improvement in product recalls	Product safety oversight
INDUSTRIALS	Penetration levels of electrified products	Structure and improvements in executive compensation
	Levels of and improvements in Scope 1 or 2 emissions intensity	Products enabling emission reductions (Scope 4)
	Safety rates	Products enabling positive social outcomes
INFORMATION TECHNOLOGY	% of revenues toward cybersecurity	Cybersecurity oversight
	% of sales linked to sustainable end markets	Products enabling social progress
	# of or improvement in cybersecurity incidents	Employee relations (turnover/engagement)
MATERIALS	Emissions intensity	Avoided emissions
	Safety rates	Supply chain audits and oversight
	% of production volumes from sustainable products	Executive compensation structure
REAL ESTATE	Emissions intensity	Developments that contribute to more affordable housing
	% of buildings outfitted with solar panels	Residential satisfaction rates
	# of or % improvement in employee training hours	Enabling improved internet connectivity in emerging markets
UTILITIES	% of electricity generated by renewables	Avoided emissions
	Emissions intensity	Improvements in regulatory environment/structure
	% of capital expenditures linked to grid hardening/reliability	Executive compensation structure

Source: American Century Investments.

This KPI framework is important to the Global Sustainable Value investment process for three reasons:

1. We use it to hold ourselves accountable when owning a stock.
2. We use it to hold management teams accountable for continually making progress on their Improvement Pathways.
3. It's highly transparent and allows for robust client reporting.

Engagement and Escalation Process

To ensure business model progression, we engage with management across all holdings in the portfolio. If these efforts do not yield the desired result, we escalate our engagement to the board level and vote our proxies to influence corporate behavior.

SUSTAINABLE VALUE: THE WAY FORWARD

We embed sustainability in our investment process because it is essential in understanding the risks and opportunities companies face, impacts economic growth and is vital to the world. Our best-in-progress-focused approach reflects our belief that investing informed by sustainability can reveal opportunities in virtually every industry. This mindset can allow investors to diversify their portfolios and realize value even from out-of-favor sectors. Importantly, it dispels the outdated idea that value investing primarily targets companies that are unaligned with sustainability principles.

Applying a best-in-progress perspective to identify companies on a meaningful Improvement Pathway to sustainability has the potential to enhance alpha generation and drive real-world outcomes while avoiding style tilts often associated with more traditional forms of sustainable investing.

This strategy offers an opportunity to generate returns from businesses that provide benefits to the world around them as they transition to sustainability.

CASE STUDY

Commitment to Sustainability | Baker Hughes

Baker Hughes is one of the world's largest energy services providers, offering diverse technologies and services across the energy landscape. To position itself to thrive during the energy transition, the company repurposed proprietary turbine and gas compression equipment to serve energy transition-related end markets: hydrogen, carbon capture utilization and storage (CCUS), and liquified natural gas (LNG).

- It utilizes proprietary compression technology to enable the liquefaction of natural gas. This transition fuel continues to take energy share from coal as the world weans itself off higher GHG-emitting energy sources. Baker Hughes has dominated this market, accumulating around 90% market share for gas compression equipment serving LNG markets. Its backlog of related equipment has grown immensely, eclipsing $27 billion in Q2 2023. (Source: BKR filings.)
- The same technology enables the company to provide CCUS services. Though this end market is nascent, the IEA expects annual CCUS expenditures will need to be in the hundreds of millions for the world to reach net zero by 2050[5]. We think Baker Hughes is well-positioned to capture a fair share of this spending.
- Unlike many competitors, Baker Hughes has orders to prove it can serve the hydrogen markets, which the IEA expects to quintuple by 2050[6]. For example, in 2020, Baker Hughes and natural gas operator Snam tested what the companies said was the world's first hydrogen blend turbine for natural gas networks.

Baker Hughes has proven its commitment to sustainability by actively repositioning its business. If the world follows the IEA's net zero by 2050 pathway, the growth Baker Hughes would see in its energy transition-related end markets would offset any degradation seen to its legacy fossil fuel-based end markets and its net earnings power would increase. Given its better-than-peer positioning, we expect this to drive significant outperformance relative to competitors.

References to specific securities are for illustrative purposes only and are not intended as recommendations to purchase or sell securities. Opinions and estimates offered constitute our judgment and, along with other portfolio data, are subject to change without notice.

[5] IEA Net Zero by 2050 Report
[6] Ibid.

CASE STUDY

Operational Improvement | Dollar Tree, Inc.

Running a retailer often means dealing with constant employee turnover. Yet Dollar Tree Inc., a U.S.-based discount retailer that operates 16,000 Dollar Tree and Family Dollar store locations, sought to buck that conventional wisdom with investments in wages and safety to keep employees around for longer.

- In 2022, Dollar Tree reported a $360 million investment to increase wages at its corporate headquarters, stores and distribution centers. That reduced store manager vacancies by 32% year over year and, in 2022, reduced store leadership turnover by almost 14%. The median employee salary grew 9% from 2021-2022, according to company proxy statements.
- Dollar Tree's low price points made the retailer particularly susceptible to cost increases of a disrupted supply chain in the aftermath of the pandemic. The company responded by investing in supply chain upgrades, including an automation system to lower the cost of restocking shelves. The social benefit of this automation includes reducing the physical toll on employees in the typically labor-intensive practice of stocking shelves, which also contributes to stemming employee turnover.

Investors often associate sustainability with climate or other environmental outcomes. But improving social outcomes also improves a business model's sustainability. In Dollar Tree, we see a company that has made employees a higher priority in terms of pay and safety, resulting in better outcomes for workers and proven financial benefits, such as lower employee turnover and better merchandising.

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CASE STUDY

Attractively Valued Sustainability Leader | EQT Corp.

EQT is the largest natural gas producer in the U.S. It operates primarily in Appalachia, a region that follows a mountain range in the eastern and northeastern U.S. The company's sole focus is natural gas, which is minimally a transition fuel if not a future lower-carbon baseload energy source. Natural gas continues to take share from coal as the world weans itself off higher-emitting energy sources.

- EQT embarked on a path to reach net zero Scope 1 and Scope 2 emissions by 2025. Most competitors plan to reach the same milestone by 2050.
- Natural gas production often leaks methane. In 2021, EQT announced it would replace 9,000 natural gas pneumatic devices with those powered by electricity, compressed air and other means. In January 2023, EQT said that completing this $28 million initiative reduced methane emissions by 70%.

EQT stands apart from its competitors due to its industry-leading environmental credentials. Yet its stock is valued like any other fossil fuel producer, with the market giving the company no credit for its much more sustainable business model. We think this disconnect provides an attractive investment opportunity.

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CASE STUDY

Sustainability Enabler | Husqvarna

Husqvarna is a Swedish manufacturer of power tools for forest, park and lawn care, including chainsaws, grass trimmers and lawnmowers. Combustion engines typically power these tools, but Husqvarna started shifting its production to battery-powered devices to enable its customers to reduce their carbon footprints.

- Husqvarna announced in 2022 that it would hasten its transition to sustainable and higher-margin products, partly by exiting several petrol-powered products by 2024, which account for $196 million (2 billion SEK) in annual sales. The company has developed a battery-powered equivalent for all its handheld products, including chainsaws and leaf blowers.
- Today, about 34% of Husqvarna's motorized revenue is electric. As it transitions from low-margin petrol-powered products, the percentage of revenue from electrified motors should increase to 42%. By 2026, the company plans to electrify 67% of its products.
- Husqvarna developed a CEORA™ robotic autonomous mower for commercial lawn care comparable to what the Roomba® robot vacuum did for indoor cleaning. Users set virtual boundaries for an area and set the mower to cut grass or aerate on its own. The mower reduces emissions by 84% over its lifecycle compared to riding lawnmowers.
- Husqvarna's business transition coincides with an evolving regulatory environment. The California legislature passed legislation (AB 1346) prohibiting the sale of small gas-powered engines with 25 horsepower or less by 2024, with other cities considering similar measures to cut down on emissions from lawn care device engines.

Combustion engines historically propelled the lawn care industry and are a sneaky source of GHG emissions.[7] Husqvarna decided to transition its products to a more sustainable power source, enabling customers to reduce their GHG footprints and improving the sustainability of its business model.

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[7] Anastasia Hufham, "Environmental Advisory Council talks leaf blowers," Yale News, December 3, 2021.

ESG DISCLOSURES

Many of American Century's investment strategies incorporate the consideration of environmental, social, and/or governance (ESG) factors into their investment processes in addition to traditional financial analysis. However, when doing so, the portfolio managers may not consider ESG factors with respect to every investment decision and, even when such factors are considered, they may conclude that other attributes of an investment outweigh ESG considerations when making decisions for the portfolio. The consideration of ESG factors may limit the investment opportunities available to a portfolio, and the portfolio may perform differently than those that do not incorporate ESG considerations. ESG data used by the portfolio managers often lacks standardization, consistency, and transparency, and for certain companies such data may not be available, complete, or accurate.

ESG DEFINITIONS

- ESG Integrated: An investment strategy that integrates ESG factors aims to make investment decisions through the analysis of ESG factors alongside other financial variables in an effort to deliver superior, long-term, risk-adjusted returns. Therefore, ESG factors may limit the investment opportunities available, and the portfolio may perform differently than those that do not incorporate ESG factors. Portfolio managers have ultimate discretion in how ESG issues may impact a portfolio's holdings, and depending on their analysis, investment decisions may not be affected by ESG factors.
- ESG Focused: An investment strategy that focuses on ESG factors seeks to invest, under normal market conditions, in securities that meet certain ESG criteria or standards in an effort to promote sustainable characteristics, in addition to seeking superior, long-term, risk-adjusted returns. This investment focus may limit the investment opportunities available to a portfolio. Therefore, the portfolio may underperform or perform differently than other portfolios that do not have an ESG investment focus. ESG-focused investment strategies include but are not limited to impact, best-in-class, positive screening, exclusionary, and thematic approaches.

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