ESG Investing Award Interview
Pzena Investment Management

Background/Introduction

Overview: Pzena Investment Management

Pzena Investment Management LLC is an investment manager based in New York City with a strict focus on long-term classic value investing. The firm was founded in late 1995 and began managing assets on January 1, 1996. Since the firm's inception, Pzena has built a diverse, global client base of institutional and retail investors. Pzena has offices in New York, London, Dublin, Sydney, and Melbourne.

The premise of our ESG-integrated research process is that the philosophy of value investing and the principles of ESG integration are harmonious. As value managers, we look to improvement in business fundamentals as a source of excess return. Where ESG issues are financially material, ESG improvement may also be a source of alpha.

ESG Team

The entire investment team at Pzena is, in one sense, our ESG team. Investment analysts and portfolio managers are responsible for considering company-specific financially material ESG issues as part of our ESG-integrated investment process. They are best placed to understand how ESG affects the value opportunity at stake for a given company.

We also think it is important to have dedicated ESG professionals as part of the investment team to help continuously develop the firm's thinking on ESG matters and lead our thematic ESG research. This research combines priorities from the ESG investment community with our perspective on what may lead to superior investment returns and/or is practically applicable to our investment process.

That ESG team is comprised of the following individuals:

Rachel Segal, Head of ESG

Rachel joined Pzena in 2019 and is responsible for ESG-related research and manages the ESG team. Prior to joining Pzena, Rachel spent 10 years as a sustainability consultant, both internally at BNY Mellon and in client service at PwC. Rachel earned a B.A. from Cambridge University and an M.A. from The Johns Hopkins School of Advanced International Studies (SAIS).

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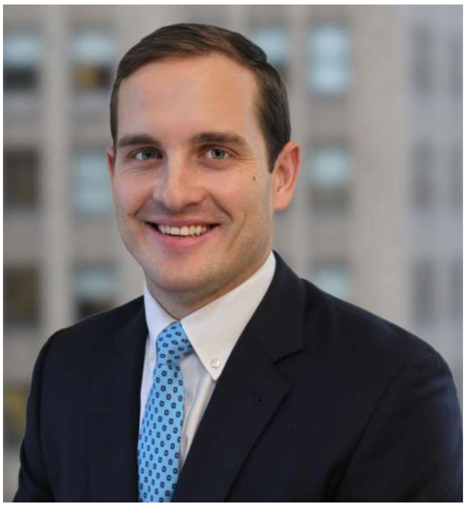
Luke Longinotti, ESG Research Analyst

Luke joined Pzena in 2021 and focuses on ESG-related research. Prior to joining Pzena Luke was a consultant at Casey Quirk, a strategic consulting practice operating within Deloitte Consulting, where he focused on investment management strategy. Mr. Longinotti graduated with a B.A. from Yale University.



Anna Doran, Senior ESG Reporting Associate

Anna joined Pzena in 2017 and joined the ESG team in 2021 where she is focused on ESG reporting. She was previously the Research Team Assistant for 3 years. Anna earned a B.S. in Environmental Science from Union College and an MSc from the Columbia University School of Professional Studies in Sustainability Management.

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Start of Q&A

Approach to ESG

How do you approach ESG?

At Pzena we pursue ESG integration and approach ESG as part of our fundamental bottom-up research process. Value investing is an opportunity to buy a good business 'on sale.' For those value stocks that are also ESG laggards, part of the investment opportunity is the potential for improvement in material ESG considerations. Our ESG-integrated research process therefore reflects a forward-looking assessment of a company's specific material ESG risks and opportunities. We do not rely on a mechanistic third party ESG score-driven approach.

And what about engagement?

We see it as central to our investment process. ESG improvement can only come from a willingness to act like an owner and engage to try and influence the trajectory of the company in the direction of long-term shareholder value creation. Divestment, in our view, abdicates this responsibility. Engagement both informs our thinking of material ESG issues facing companies and gives us a forum to advocate for change, where needed, at specific companies we own.

Do the ESG analysts ever work directly with the investment analysts on ESG research?

Yes. While we want the investment analysts to take the lead on ESG for companies under their coverage, we expect that they also collaborate with the ESG team as our in-house subject matter experts. For example, our auto analyst collaborated with the ESG team on a deep-dive into the economics of EV battery recycling for OEMs. The ESG team also systematically consults the relevant analyst on every name moving through our research process to discuss any material ESG issues.

Value/ESG

When one thinks of the classic value sectors, one thinks of financials, energy producers, steel companies, etc. These don't sound very ESG friendly. How do you reconcile ESG investing with investing in industries like that?

It just depends on one's definition of ESG. We do not believe in "good" or "bad" ESG companies. Given we focus on ESG improvement, the starting point of a company's ESG journey is less relevant.

That is why we created the Pzena Opportunity List which seeks to systematically identify opportunities in our portfolio where material ESG issues exist and engagement *could* have a positive impact. Once a company is placed on the Opportunity List, we create an engagement plan with specific objectives and milestones to track progress. In practice, progress against the engagement plan will not manifest all at once, but will appear in incremental steps over the investment time horizon.

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The judges noted that "Pzena has produced quality ESG research on ESG integration and in-depth research on the relationship between ESG scores and stock performance." Could you elaborate a bit, especially on the relationship between ESG scores and stock performance, and how this influences your approach?

To empirically test our philosophy of ESG improvement, we used MSCI ESG scores as an (albeit imperfect) ESG proxy and compared both point in time ESG score and change in ESG score over time to investment performance. Through this proprietary research, we observed a significantly stronger relationship between investment performance and change in ESG score over time. While there are several limitations to this analysis (further discussed in the research paper), we believe the findings are directionally indicative of the alpha-generation potential from ESG improvement. A combination of deep research and extensive engagement is necessary for investors to access this potential source of alpha generation.

Engagement

You recently signed up to the Net Zero Asset Manager initiative (NZAMi). How does your commitment to Net Zero manifest itself in your engagement with companies you invest in?

Climate change poses risks to many industries that must undergo costly transitions to pivot legacy business models. Given the associated financial implications, it is critically important that we assess, mitigate, manage, and monitor the climate risks and opportunities specific to each individual investment. We believe engagement with companies to improve business resilience and operating practices can be more effective in accelerating decarbonization efforts and driving change than an exclusionary approach based on third-party data.

As part of our commitment to the NZAMi, we have launched a new Global Value Climate portfolio. For clients that decide to invest in this strategy, we have more explicit climate-related metrics and targets aligned with the Paris Aligned Investment Initiative Net Zero Framework. This includes assessing the credibility of Net Zero plans and continuing to engage 'high impact' companies not yet aligned to a Net Zero pathway.

Could you provide an example how you have engaged with a company that scored poorly on ESG?

A classic example is Volkswagen. From a third-party ESG ratings perspective, Volkswagen is a poor performer, largely related to the fallout from the 2015 "Dieselgate" emissions scandal. ESG improvement has been central to our investment thesis for Volkswagen, which made it a natural candidate for our Opportunity List. We spend considerable time engaging with management on the two most material ESG considerations: electrification and corporate governance. In general, we are pleased with Volkswagen's electrification strategy, though continue to monitor how the strategy may need to evolve to meet tightening EU emissions standards. Unfortunately, we see ongoing governance deficiencies and continue to engage in the hope that we will see improvement.

Emerging Topics

Biodiversity is a hot topic at the moment. Has Pzena done any work on this and what conclusions can you share?

Yes, this was one of the thematic focuses in 2022, and we continue to monitor developments. Currently, our view is that biodiversity is still relatively difficult to financialize for a given company. There are no universally accepted measures of biodiversity and associated data availability/quality is questionable. Some sectors are financially at risk because they are dependent on biodiversity and ecosystem services, while others are more at risk from a regulatory and reputational standpoint because of their high impact on biodiversity. There are also inextricable connections between biodiversity and other ESG issues, such as climate change and water scarcity. We can, however, try to manage the risk through our assessment of the range of outcomes for an investment and ongoing engagement.

Are there any other emerging ESG issues you are looking at?

Yes, one of the current thematic research priorities for the ESG team is water. We are investigating how water scarcity can become an investment risk and helping to identify where there may be hidden water risk in our portfolios.