Integration of sustainability into our research process

DEEP RESEARCH FUND

Our approach

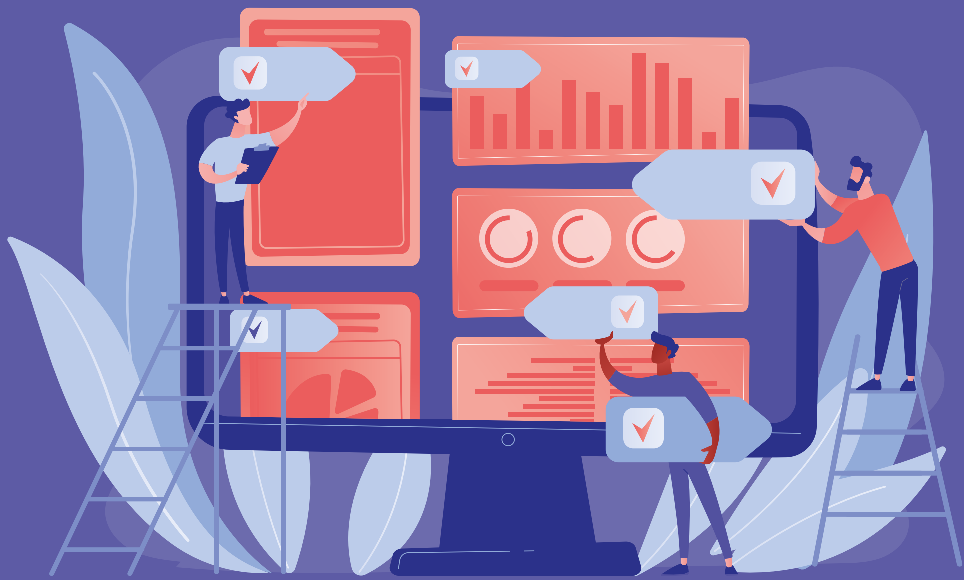
The Deep Research Fund's objective is to generate a return for its clients by carefully selecting and investing in companies that can withstand difficult times, are managed with the long-term view in mind, and comply with high sustainability standards. To implement these sustainability standards, we systematically integrate our sustainability concerns in all parts of our investment process.

Whether it is the initial quantitative screening process, the in-depth research phase, or the final portfolio construction, sustainability plays an important role in each step of our decision-making. In our Exclusion Insight, we outline how we define and exclude the type of companies we would not invest in. In this publication, we would like to show how we systematically integrate our sustainability considerations for those companies we are actually interested in. We will underline the different methods we use in both the quantitative and qualitative stages of our investment process and highlight some of the challenges we are facing. Ultimately, we hope to help the reader understand how sustainability issues are considered in our investment strategy.

Our sustainability considerations are based on two foundations. You can read about the first foundation in the Sustainability Insight which describes our sustainability workshops and how we distilled our shared personal values into guiding sustainability principles for our investment research.

The second foundation is based on the Sustainability Accounting Standards Board (SASB) materiality map, which outlines the key issues related to environmental & social impact as well as governance challenges for each industry. By integrating both our values as well as an expert-driven framework from the SASB, we can achieve a holistic understanding of a company's sustainability. It is not always easy as some aspects of sustainability are better suited for quantitative research and some other aspects shine better through a qualitative analysis.

Over time, we had many discussions on how to best tackle the various problems, at what stage in the research process a given concern is best addressed, and how we arrive at a decision when faced with two conflicting issues or a situation where our ideal level cannot be reached and a "good enough" threshold has to be defined. In order to not lose sight of our priorities, we tried to clearly define which sustainability issue is best addressed in which step of our research. Below we try to illustrate how we go about tackling the various challenges.



How to best address sustainability in our research

Let’s start with a brief overview of our process. When looking for companies to invest in, we start by screening the global universe based on purely quantitative parameters and narrow it down to a number of companies we can handle. Then, we create a short pre-check of each remaining company where we start to take qualitative factors into consideration. Those companies we like the most, we research in great detail, which we call the in-depth research stage. Each stage offers an opportunity to address sustainability concerns.

At the end of 2021, there were about 98’000 publicly traded companies globally. By implementing our exclusions, we narrow down this universe to about 1’500 companies. We screen these 1’500 stocks based on quantifiable factors to reduce them down to about 50. This means we have to remove 29 out of every 30 companies in a way that is meaningful, consistent, and efficient. The best 50 companies are moved to the next stage, the rest are discarded. Sounds simple, right? As always, the devil is in the details.

To narrow down our investment universe, we weight the economic and sustainability data for each company to create a composite score. The composite score captures those aspects of sustainability that can be measured quantitatively. If we want to measure diversity or climate risk, we would use data on the share of women in the executive team, for instance, and the carbon intensity of the company, respectively. These would be quantitative values, and as a result we would have no deeper understanding why a company may have high CO_2 emissions.

This approach mirrors what happens with financial metrics at this stage of research; we also do not know why a given company has a particularly high profit margin or low valuation. The composite score simply helps us tilt the list of companies we later research towards our preferred type of company. This is a fast and efficient way of weeding out companies with low sustainability scores, weak economics or high leverage. The drawback is that we might miss out on a company going through changes. Since we repeat this quantitative process twice a year, we hope to catch those companies once their metrics improve at the next quantitative research stage.

The second stage of our investment process we call the pre-check stage. A “pre-check” is a standardized report filled out by one of our analysts to ensure that our “no-go” criteria are not breached and to briefly assess the sensitive topics related to each company. The sustainability section of a precheck report needs to answer several questions.

Figure 1: Summary of the steps in the research process

	Investment Process
Step 1: Screening	Narrow down the investment universe to companies fulfilling minimum acceptable financial criteria. Rank companies on short list based on financial criteria
Step 2: Pre-Check	Eliminate companies with unsuitable business models or financials
Step 3: In-depth	Quantitative and qualitative deep-dive into the selected company
Step 4: Stock Selection	Select stocks for the portfolio based on competitiveness, financials and sustainability
Step 5: Monitoring	Once invested, regularly engage with company and monitor financial performance

Our sustainability process mirrors our financial research – this helps us make informed decisions at every step of our research process.

The first key question considers whether the company specific business model aligns with our values. In the past, for example, we excluded a company because we realized that its business is based on production of single-use office supplies. There is no good reason why an office pen or a paper clip could not be made durable to withstand repeated usage.

As a result, we excluded this company from our investable universe altogether. Another example could be a company, which was not classified as a military supplier based on its data set, yet a significant amount of its revenue was derived from contracts with the military. These are examples of issues that are hard to catch based on numbers only.

The second key question is whether our sustainability minimum standards are upheld. For this purpose we developed a flag system to be alerted whenever the sustainability performance of a company does not meet our minimum criteria (Figure 2). The themes in the flag system are primarily based on our workshops and are thus based on our values and preferences. A red flag appears whenever a company does not meet our minimum criteria in a particular issue. This helps us catch a killer criteria early on and terminate the research before spending weeks or months on in-depth research.

The third key question in any precheck report is whether there is enough information for us to conduct an in-depth research report. Since we spend several days on a precheck, this gives us sufficient time to get an impression of a company's transparency and reporting quality and to assess whether we have all necessary information with sufficient validity to conduct further research on a company.

About one in ten companies passes our precheck stage. If it passes, we initiate a full-fledged research report. The in-depth stage entails extensive research into the business model, financial reporting, culture, competitive position, risk exposures and sustainability profile of a company. In terms of sustainability, we now have the time to go far beyond the precheck both in terms of the breadth of topics and the depth of analysis. Let's illustrate this with our examples.

Diversity in the previous research stages was addressed using the parameters: share of women on the board of directors and executive committee. This is because we find gender diversity important, easier to quantify, and companies frequently report on this ratio. During our in-depth research, we broaden our understanding of diversity. We look for board of director compositions with varied professional experience, age, and backgrounds. We analyze the CVs of the directors on the board and all executive team members and evaluate whether these teams have diverse enough backgrounds to oversee and run the company we are researching. For example, we once excluded a company from further research because every member of the executive team had a background in marketing. We also excluded a company where the board – although diverse in terms of gender and educational background - was composed of family members that were also related to management.

Similarly, we prefer companies where Chair of the Board and the CEO are two different people. We believe that the separation of these roles is better for the company oversight as well as its risk management. However, this criterion is a preference and not an exclusion metric, meaning that in the precheck stage we would highlight the potential overlap between the two roles as an issue to be researched but not discard the company from the research universe if other metrics meet our criteria.

Figure 2: Anrepa's Deep Research Fund Flag System

#	Sustainability	Metric	Flag
1	% of Non-Exec Directors on 3+ Boards	9%	✔
2	% of Exec Directors on 2+ Boards	#N/A N/A	! ⚑
3	# of Boards the CEO Serves on Other Firms	1	✔
4	# of Executive Positions Chairman Holds in Other Firms	0	✔
5	% of Women on Executive Committee	22%	× ⚑
6	% of Women on Board of Directors	27%	× ⚑
7	Board of Director Age Range	13	× ⚑
8	% of Non Executive Directors on Audit Committee	100%	✔
9	% of Audit Committee Members on 3+ Boards	0%	✔
10	Independent Audit Chairman	Y	✔
11	% Independent Directors on Audit Committee	100%	✔
12	CEO Duality	N	✔
13	% Non Executive Directors Compensation Committee	100%	✔
14	% of Board Compensation Paid in Stock Awards	0%	✔
15	Shares Held by CEO as % of Outstanding Shares	0.0%	× ⚑
16	Total Options Award Given to Executives	0	✔
17	Carbon Intensity Reported	10.2	10.2
18	Carbon Intensity Filled In	16.7	CO_2 / Revenue in USD
19	Policy on Anti-Bribery	Y	✔
20	Policy on Sustainable Supplier Guidance	Y	✔
21	Policy on Water	Y	✔
22	Policy on Human Rights	Y	✔
23	Policy on Anti Child Labour	Y	✔
24	Policy on Business Ethics	Y	✔
25	Policy on Health/Saftey	Y	✔
26	Policy on Employee Training	Y	✔
		# of flags:	**4**

This example of our flag system illustrates how we further improve data that is available to us. The majority of the information in the column called Metric is downloaded from the Bloomberg database. It is factual and helps us understand that company better. The fields that are highlighted in dark blue had to be manually filled by our analysts and the orange field is an element on which the company itself does not report. The flags indicate issue areas where the researched company does not reach our targets. Both flags and missing data will be raised during calls with investor relations of the company.

If we decided to research a company where the CEO is also Chairman of the Board, we want to understand how the Board of Directors really operates in order to provide an effective oversight of management and what the succession plans are for each of the position. We would also try to understand if there is another person balancing out the power concentration such as a major shareholder, founder or otherwise influential person. This type of information cannot be handled quantitatively which is why we focus on it in the in-depth stage where we have space for thorough qualitative analysis.

In the previous example of carbon emission, we focused on the carbon footprint in the early stages of the research because it is a quantifiable value that can be easily compared to peers. In the in-depth research stage, we would focus on the transition aspect of the company's emission. Are there any targets in place? Can we trust and verify those targets? What actions are the peers undertaking and can we consider this company to be a leader or a laggard? We will be in direct contact with the company to understand why certain alternatives have not been explored or talk to people within the company and former employees to get a feel for how serious implementation efforts are. This helps us also understand whether the management acts based on outside pressure or personal conviction.

Does the management have the courage to initiate change within the industry? In this stage, we allow ourselves to take the time to really dig deep into the culture of a company to understand where it is today, and where it might be tomorrow.

Example: Sustainability & financials
Our precheck identified a company producing hygiene products as an interesting candidate for in-depth research. In a business we considered commodity-like, we were surprised to see profit margins significantly higher than the peers. Given the potential environmental issues linked to hygiene products, we decided to start the in-depth research with a sustainability analysis. Using the materiality map, we quickly realized that the improved margins came from using cheaper (and dirtier) sources of energy. Once the company would comply with the upcoming government regulations, its margins would level with its peers who were already compliant with the regulation. Hence, we discarded this research and moved on to analyzing another company.

How do we know what issues warrant a rigorous investigation? The breath of the sustainability research in the in-depth stage is driven by the materiality map from the Sustainability Accounting Standards Board (SASB). The tool outlines which topics are material, i.e. meaningful, for each industry. While the precheck helps us focus on the sustainability criteria that we as a team find important, the SASB's materiality map points us to the crucial issues in each industry that are now taken into consideration.

In Figure 3 we are providing an example of material topics for Stock Exchanges and for Software companies. Today, most stock exchanges no longer include a pit where people trade in person; rather, the exchange has moved online and trading is done electronically through trading software. Often this software is developed in house. So one might think that securities exchange and software companies might have similar sustainability issues. And yet, the topics that are highlighted by the SASB's materiality map are substantially different. This is why we find it important to work with the materiality map that was developed in collaboration with sustainability experts in each industry. As a result of this approach, the outcomes of the sustainability research differ from company to company. What stays constant is the rigor of the analysis, the links to the financial analysis, and the ultimate impact of the sustainability analysis.

Throughout our in-depth stage, we are in touch with the company we research several times. These repeated calls provide us with the opportunity to raise sustainability issues that we have identified and discuss the more forward-looking elements of the sustainability strategy. These inquiries also help highlight to the company itself that the investor community values sustainable behavior. For example, we researched a company based in the USA that did not have a convincing sustainability strategy in place and was not setting any sustainability targets, although its metrics in the flag system were sufficient to move to the in-depth research stage. We talked to the company several times, highlighting these issues. Since the company did not show any serious interest in these topics and our concerns were not addressed, we had to put the research aside. A few months later, the company reached out to us explaining that our concerns helped change the internal thinking and the company is now working on a sustainability strategy. This helped us move the company back into our research universe and if it ever proceeds from the screening stage again, we will be ready with our research and our existing relationship with the company.

Figure 3: Examples of Material Topics

Industry	Material Disclosure Topic by SASB
Security & Commodity Exchanges	– Promoting Transparent & Efficient Capital Markets – Managing Conflicts of Interest – Managing Business Continuity & Technology Risks
Software & IT Services	– Environmental Footprint of Hardware Infrastructure – Data Privacy & Freedom of Expression – Data Security – Recruiting & Managing a Global, Diverse & Skilled Workforce – Intellectual Property Protection & Competitive Behavior – Managing Systemic Risks from Technology Disruptions

Stock Selection and the Impact of sustainability integration

When we conclude research on a company, we discuss the potential investment in our investment committee. All aspects of the company are challenged by the team: the business model, competitive position within the industry, leadership and culture, risk profile, valuation, and all sustainability aspects. Each element by itself can lead to the company being discarded. Only companies that truly match all our high standards are considered for the portfolio.

If a company is too expensive, we don't invest no matter how much we like the business model or how sustainable we find the company. And should a company not meet our sustainability standards, we don't invest regardless of how attractive the valuation of the stock is. Each aspect has its own veto power. At the same time, the number of companies in our portfolio is fairly stable. This means that often our research target has to be better than a company that's already in our portfolio. Should we like the company and decide to invest, then we mostly replace one of our existing investments with the goal to improve the portfolio overall.

Step by step, we try to improve the sample of companies we are interested in until only a few are left to finally be considered as potential investment. Since a new investment most often replaces an existing portfolio company, this sets a high bar for any new stock, and also continuously challenges the current portfolio. Below, we provide the improvement of the metrics used as example based on our 2021 winter research cycle, which lasted about 6 months.

Once we invest in a company, we monitor its operations and performance. We hold the management accountable to its promises, stay in touch regularly and bring up relevant sustainability and financial issues when we talk to the company, visit their premises or vote at the Annual General Meeting. This also creates a meaningful relationship with the companies. In the past, management of portfolio companies have reached out to us to ask about our opinion on various internal initiatives. A marine company, for instance, wanted to know how we feel about them spending money on retrofitting diesel engines for biofuel. This had no economic benefit and was simply to gauge customers interest to carry the extra cost for a project being completed with lower emission. We supported the initiative and were excited to see a push for greener energy in an industry that still has a long way to go.

Figure 4: Fall 2021 Statistics

	Women on Board of Directors	**Women on Executive Committee**	**CO_2 intensity average**	**Power Concentration (lower number more desirable)**
Universe	21.0%	14.0%	161.6	42%*
Screening	32.0%	17.0%	133.9	30%
Precheck	30.0%	19.6%	88.4	26%
In-Depth Research	33.4%	27.7%	25.4	20%
Invested	45.5%	20.0%	3.5	0%

Figure 4 compares selected sustainability values from universe through precheck to in-depth. It shows a continuous improvement in our sustainability values.
*S&P500

Concluding thoughts

It is a standard industry practice to segment sustainability concerns into three buckets: environmental, social, and governance concerns. We follow this methodology to gain a general overview of all identified issues we want to address later in the research process. However, once we get into the detailed research stage, often the separation of environmental, social, and governance aspects of sustainability loses its usefulness.

For instance, a company stating the environmental goal of reducing its CO_2 emission would have to prove its intention by incentivizing management accordingly. In our governance analysis, we would then analyze the management compensation looking for tangible incentives such as increased bonus for achieving a greener energy mix than in the previous year. Therefore, it is more useful for us to view sustainability holistically and understand how the various issues intertwine and influence each other.

Another example of a challenge we may face can be found in our push for diversity. Diversity is usually thought of as a "social" issue or sometimes it is considered a "governance" issue. Since we view sustainability holistically, it does not really matter to us to which part of ESG it belongs. Rather, we see it as both sustainability and a risk management topic as more diverse teams can address broader range of issues and are less prone to in-group thinking.

As mentioned above, before we can arrive at a well rounded view of management's diversity, we focus on gender balance as it can be assessed quantitatively. This is often less straight-forward than one might think. For example, since the 2021 adoption of the Rixain Law in France, large French companies have to achieve at least 30 % of women in mid and upper management by 2026. Many other countries do not push their companies similarly. As of 2021, companies listed in Germany had the share of women in management at 8.2 % and companies listed in Japan even at 2.3 %.

Our expectations don't change from country to country, however, what can be considered progressive must be seen in the context of each respective country. Once a French company reaches 30 % of share of women in management, it just meets its regulatory minimum. If a Japanese company reaches a similar ratio, it clearly wants to push for gender diversity. For us, this means that we have to view sustainability holistically and to understand data in its cultural context. This can sometimes be a challenge but we try our best. If we feel we are not doing enough, or have an idea how to further improve our process, we implement the desired changes in the next research cycle.

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