The Case for Active Management in ESG – It's All About the Governance

SATURNA CAPITAL

FROM THE YARDARM
MARKET COMMENTARY & ANALYSIS

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About Saturna Capital

Saturna Capital, manager of the Amana, Saturna Sustainable, Sextant, and Idaho Tax-Exempt Funds, uses years of investment experience to aid investors in navigating today's volatile markets. Founded in 1989 by professionals with extensive experience, Saturna has helped individuals and institutions build wealth, earn income, and preserve capital.

Saturna's deep-rooted belief in value investing shines through in the quality of our investments. We don't follow trends, we analyze opportunities. Years of experience have given Saturna financial strength and stability. Most important to Saturna's success, however, is our clients' success. We believe that our clients' interest always come first.

At Saturna, we believe in making your investment dollars work hard for you. Toward this end, Saturna strives to not only offer the best investment opportunities from mutual funds to IRAs, but to match those sound investments with superior customer service.

Amana Mutual Funds Trust

SEXTANT MUTUAL FUNDS

IDAHO TAX-EXEMPT FUND

SATURNA SUSTAINABLE FUNDS

Please consider an investment's objectives, risks, charges, and expenses carefully before investing. To obtain this and other important information about the Amana, Sextant, Idaho Tax-Exempt, and Saturna Sustainable Funds in a current prospectus or summary prospectus, please visit www.saturna.com or call toll free 1-800-728-8762. Please read the prospectus or summary prospectus carefully before investing.

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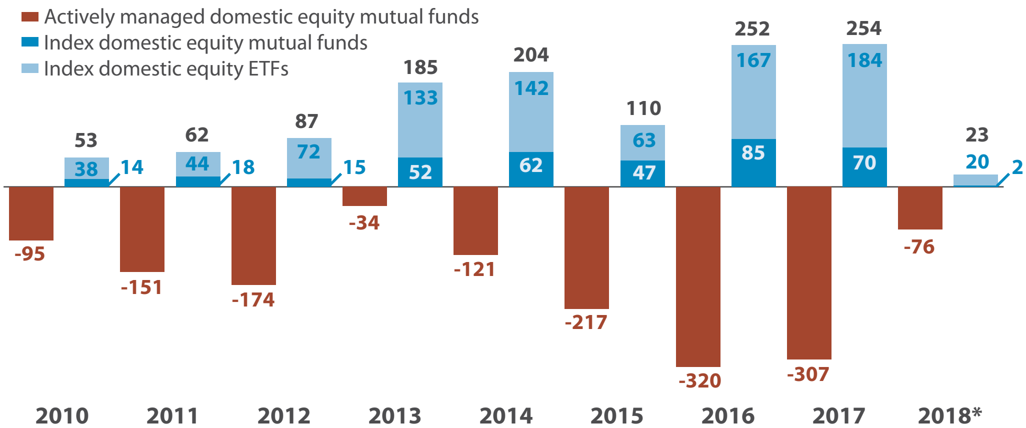
Perhaps the most dominant trend in the mutual fund industry over the past several years has been the rise of passively managed, index-tracking mutual funds and exchange traded funds (ETFs), which have supplanted a large portion of actively managed assets under management. According to the Investment Committee Institute (ICI) , actively managed domestic equity mutual funds experienced outflows every single year over the period from 2010 to 2017. More recently, outflows have gathered pace, totaling $844 million over 2015–2017. Meanwhile, ICI data shows indexed domestic equity mutual funds and ETFs have experienced consistent inflows over the same period. Morningstar, while providing slightly different figures, tells the same story.

Outflows from Actively Managed Domestic Equity Mutual Funds Continued in Early 2018

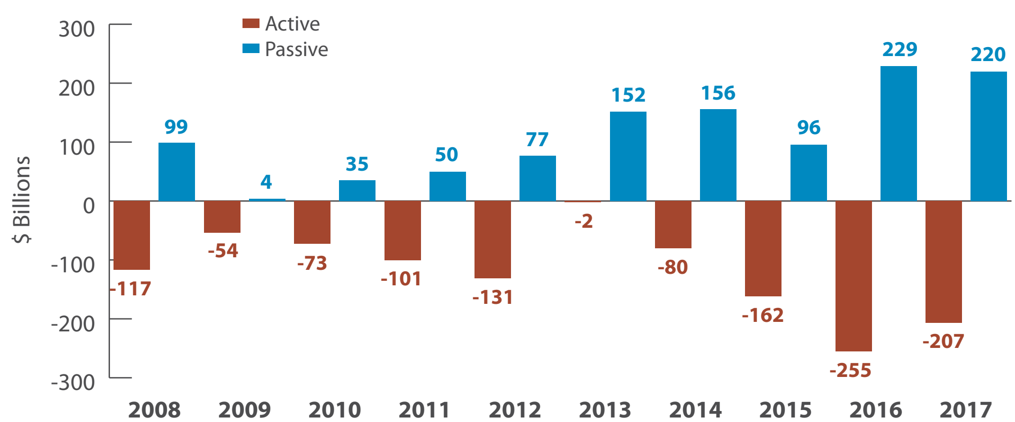
*Net new cash flow, billions of dollars, 2010-2018**



** Data through March 31, 2018*

Source: Investment Company Institute

US Equity Mutual Fund Flows



Source: Morningstar Direct

SOPHISTICATED ESG INVESTING HAS MOVED BEYOND NEGATIVE SCREENING AS THE PRIMARY DRIVER OF PORTFOLIO CONSTRUCTION

Another trend has been the growth of socially responsible investment under a variety of labels, including sustainable investing, socially responsible investing (SRI), impact investing, and, most broadly, environment, social, and governance (ESG) investing. Similar to passive funds and ETFs, ESG assets under management in mutual funds have grown rapidly, rising from $118 billion in 2001 to $1.7 trillion in 2016.[1] Given these numbers, it's no surprise that the passive crowd wants into the ESG space, using systematic indexing techniques to replicate ESG screening strategies. Recently, a major index fund provider filed with the Securities and Exchange Commission to create a US stock ETF and an international stock ETF that will screen for ESG factors. According to the firm's website, the funds will use "exclusionary" (negative) screening as well as "inclusionary" (positive) screening to select companies that rank highly on ESG criteria.

Negative screening is straightforward. Companies that produce/distribute alcohol, tobacco, fossil fuels, weapons, etc. are eliminated from consideration. Sophisticated ESG investing, however, has moved beyond negative screens as the primary driver of portfolio construction. Today's ESG investor seeks to identify companies that are setting the standard in environmental, social, and governance policies and practices, or companies that have committed to moving toward best practices with specific, measurable signposts to gauge progress. The firm mentioned above does reference "inclusionary" screening, and index providers have already designed quantitative systems that aggregate ESG data, rank companies according to their scores, and select the top tier. Even so, these quantitative ranking systems retain "black box" elements, making it difficult for investors to truly understand what they're getting.

As an example, let's examine the scores provided by a selection of ESG rating organizations for a handful of companies. In the table below, we show the ESG scores provided by Saturna Capital, Thomson Reuters Eikon, RobecoSAM, and Sustainalytics for Estée Lauder, Unilever, Pfizer, L'Oréal, Nestlé, Nike, GlaxoSmithKline, and Adidas. We have chosen this list of companies for three reasons:

1. They demonstrate how dramatically ratings agencies can differ about one company, while being in full agreement on another;
2. They show how ostensibly similar companies can have very different ratings;
3. They provide some surprising and unintuitive results.

ESG Scores Can Vary Widely Among Rating Organizations: Sample ESG Percentile Rankings

Company	Saturna	Eikon	RobecoSAM	Sustainalytics	Dispersion
Estée Lauder	81.13	78.27	33.00	21.74	30.58
Unilever	88.46	82.53	100.00	43.48	24.52
Pfizer	92.24	81.35	41.00	82.50	22.71
L'Oréal	77.49	80.76	53.00	82.61	13.81
Nestlé	74.68	73.96	100.00	96.15	13.81
Nike	63.79	67.81	76.00	57.69	7.68
GlaxoSmithKline	87.02	88.58	98.00	95.00	5.21
Adidas	87.39	88.11	97.00	92.31	4.43

ESG scores shown above are standardized as percentile rankings. Saturna Capital's ESG scores were calculated as of June 30, 2018. ESG rankings from other sources reflect scores they made available as of June 30, 2018. Availability of data used to calculate these scores varies by company reporting schedules, and may be reported on annual cycles or even less frequently. Dispersion is the standard deviation among the four sets of rankings; higher dispersion indicates greater disagreement among ranking systems.

The first thing we notice is that for companies such as Estée Lauder, Unilever, and Pfizer there are significant differences of opinion among rating organizations, as indicated by the high dispersion. Looking at Estée Lauder, we might think RobecoSAM and Sustainalytics are simply tougher graders, but, moving down to L'Oréal, Sustainalytics provides the highest score among the agencies. For Unilever, RobecoSAM assigns a perfect 100. Meanwhile, for Adidas, GlaxoSmithKline, and Nestlé, RobecoSAM and Sustainalytics assign the highest scores. The "tough graders" theory does not hold.

Similarly, we see that rating agencies can be in total agreement on one company – everyone likes Adidas and Glaxo – while holding strongly divergent views on others. We also see variations between companies in the same business. What differentiates L'Oréal from Estée Lauder, or Nike from Adidas? More to the point, how is an investor to make sense of this?

In order to answer that question, we disaggregated the ESG scores, separating them into their environmental, social, and governance components. The primary observation is that dispersion varies by category. The lowest dispersion was recorded among the environmental scores, meaning there was a lower variation among scores in this category. We found higher dispersion among the social scores, while governance scores exhibited the greatest dispersion. This is intuitively attractive given that environmental metrics, such as energy and water usage, carbon emissions, and waste management, are relatively easy to measure and score: consensus exists as to what constitutes good environmental stewardship. The same can be said of social metrics, such as worker safety, human rights, community support, and product responsibility.

When it comes to governance, however, a greater degree of subjectivity enters the picture. Of course, one can measure various governance metrics, but interpretation may vary. What constitutes appropriate board diversity and independence? Are the directors qualified and possessed of experience relevant to the firm? Is executive compensation reasonable and based on meaningful key performance indictors (KPIs)? Is management shareholder-friendly? How has management responded to challenges in the past? To illustrate the last point, let's examine two recent corporate controversies that have affected Starbucks and Nike.

In May, a Philadelphia-area Starbucks manager called the police in response to two black men entering the café and apparently waiting for their business contact to arrive before ordering. This incident was splashed across the headlines, threatening to create a narrative about endemic intolerance and racism at Starbucks. However, Starbucks quickly and proactively responded to this threat with actions that included dismissal of the responsible store manager, a personal apology by the CEO to the affected individuals, and closure of all of its stores across the country to conduct employee training in an effort to prevent such incidents from occurring in the future. The company also changed certain rules governing store management. Starbucks' response was quick, decisive, and holistic, and reflected well on the seriousness with which management viewed the event.

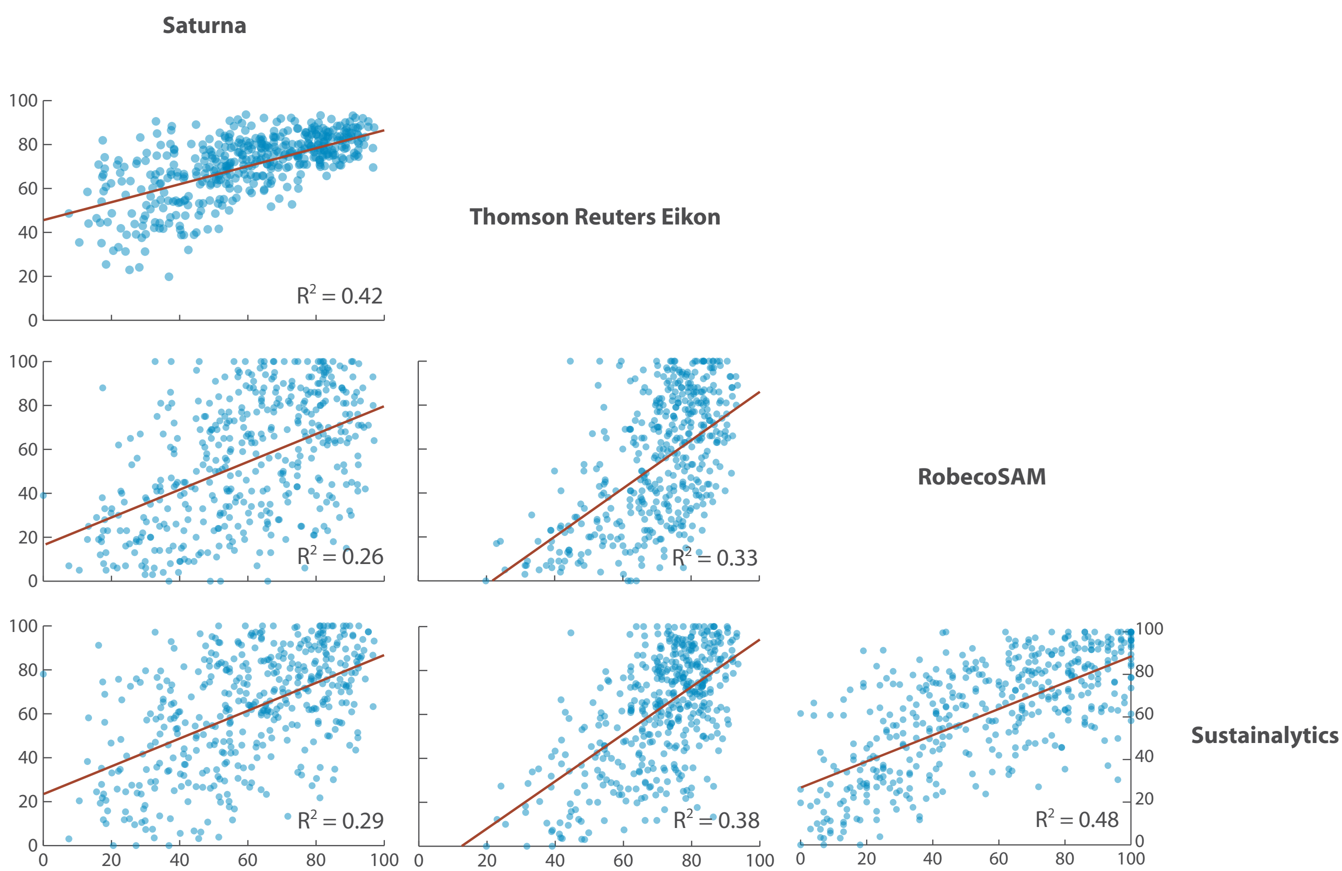
WHAT CONSTITUTES APPROPRIATE BOARD DIVERSITY AND INDEPENDENCE? ARE DIRECTORS QUALIFIED?

Contrast Starbucks' open and proactive response to that of Nike following the announced departures of several senior executives amid rumors of sexual harassment. For weeks, Nike said nothing beyond boilerplate statements regarding the departures. Eventually, the CEO addressed the entire company, and a transcript of the address was released. Still, Nike's CEO dealt only in generalities and did not specify remedial steps. Arguably, he generated more confusion than clarity, even though the events that led to the address involved several persons at the highest levels of Nike's executive team. Nike's response was slow and vague and gave the impression management was more interested in wishing the problem away rather than facing it head on.

Returning to our question of how to make sense of wide-ranging ESG scores, the inescapable answer is that mechanical scoring processes leave considerable latitude for subjectivity and interpretation. This is demonstrated clearly by the correlation charts below, which plot relationships between pairs of ESG rankings for 444 companies. We plotted scores from the ranking organizations Saturna Capital, Thomson Reuters Eikon, RobecoSAM, and Sustainalytics against each other, overlaid by a line that shows the linear fit between the two sets of scores. The ranking organization named above a given chart is plotted on the horizontal axis, while the ranking organization named to the right of the chart is plotted on the vertical axis. R^2 represents the percentage of the variation between the pair of rankings that is explained by the linear fit. The lower the R^2, the lower the agreement between the ranking agencies and, as we can see, agreement is not high. We believe a truly value-added determination requires active management and qualitative, rather than quantitative, analysis. No scoring system will be able to determine that the board is made up of the CEO's golfing buddies.

ESG Scores Can Vary Widely Among Ranking Organizations:

Correlation Plots of Pairs of ESG Rankings for 444 Companies



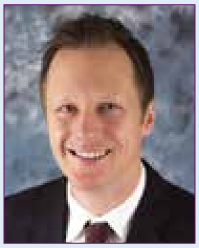
While ESG investing evolved from earlier forays into social investing, it gained momentum as a response to corporate degradation of the environment, oppressive treatment of labor, and malfeasance in the C-suite. These traits were not widespread but certainly common enough to garner attention. Over time, research has shown governance to be the most significant metric with regard to investment risk reduction. Intuitively, this makes sense, just as it makes sense that companies with the best governance are likely to be the ones treating their employees most fairly, contributing to their communities, and working to minimize their environmental impact. In short, good governance often signals hitting the ESG trifecta, while an effective determination of good governance requires more than a quantitative model. The irony is that the greatest dispersion of ESG scores, reflecting higher subjectivity and the lowest transparency for investors, occurs within the segment most clearly connected to reduced risk — a company's management and governance. A passive approach to ESG investing therefore exposes investors to risk from subjectivity and bias inherent in quantitative scoring systems, as well as the inability to distinguish the trivial from the critical, or the proactive from the reactive. In their quest to find top-tier firms that seek to reduce risk through industry best practices, ESG investors should demand more.

RESEARCH HAS SHOWN GOVERNANCE TO BE THE MOST SIGNIFICANT METRIC WITH REGARD TO INVESTMENT RISKS

About The Authors

Scott Klimo CFA
Chief Investment Officer

Scott Klimo, Chief Investment Officer and Portfolio Manager, joined Saturna Capital in May 2012. He received his BA in Asian Studies from Hamilton College in Clinton, NY and also attended the Chinese University of Hong Kong and the Mandarin Training Center in Taipei, Taiwan. Mr. Klimo has over 30 years experience in the financial industry with the first several years of his career spent living and working in a variety of Asian countries and the past 20 years working as a senior analyst, research director, and portfolio manager covering global equities. Mr. Klimo is a chartered financial analyst (CFA) charterholder. He is a supporter of various environmental organizations and served for several years on the Board of Directors of the Marin County Bicycle Coalition.



Bryce Fegley MS, CFA, CIPM
Senior Investment Analyst

Bryce Fegley, CFA, CIPM, Investment Analyst and Sextant Global High Income Fund Portfolio Manager, joined Saturna Capital in 2001 and worked in brokerage/trading and later as an investment analyst. Beginning in 2010, he spent two years as President of our Malaysian subsidiary, Saturna Sdn Bhd, directing its research and fund management operations. In 2012 he returned to Saturna Capital headquarters. Prior to joining Saturna, Mr. Fegley worked in brokerage operations in Seattle from 1997-2000. Originally from upstate New York, he studied at the University of Colorado at Boulder earning his BA in English Literature. Mr. Fegley earned an MS in Computational Finance and Risk Management from the University of Washington in December 2017. His volunteer activities include a board role with the Whatcom Family YMCA.

Footnote

[1] US SIF Report on US Sustainable, Responsible and Impact Investing Trends, 11th Edition, The Forum for Sustainable and Responsible Investment, 2016, page 36.

Important Disclaimers and Disclosures

As of June 30, 2018 the securities mentioned comprised the following amounts of Saturna affiliated mutual funds' portfolios:

Company / Fund	Amana Income	Amana Gowth	Amana Developing World	Saturna Sustainable Equity	Saturna Sustainable Bond
Adidas				1.15%	
Estée Lauder		3.86%			
GlaxoSmithKline	1.04%				
L'Oréal				1.94%	
Nestlé				1.39%	1.37%
Nike	2.65%				
Pfizer	3.15%				
Starbucks				1.50%	1.63%
Unilever	1.36%		2.75%	2.70%	

Company / Fund	Sextant Bond Income	Sextant Core	Sextant Global High Income	Sextant Growth	Sextant International
Adidas					
Estée Lauder					
GlaxoSmithKline			1.38%		
L'Oréal					
Nestlé		0.96%			
Nike				2.07%	
Pfizer		1.20%			
Starbucks				1.81%	
Unilever	2.48%	0.46%			4.43%

As of June 30, 2018, Amana Participation, Sextant Short-Term Bond, and Idaho Tax-Exempt Funds did not own any of the securities mentioned.

SATURNA CAPITAL

1300 N. State Street
Bellingham, WA 98225-4730
www.saturna.com