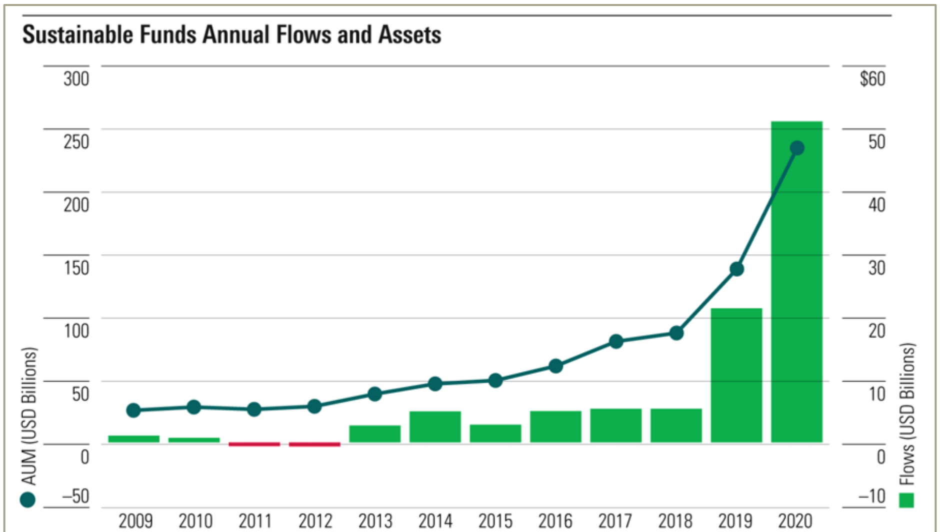
"Problems cannot be solved at the same level of awareness that created them."

- Albert Einstein

It is likely you have seen the acronyms "ESG" and "SRI" more frequently in financial literature over the past few years. As our society has increased its focus on environmental and social justice issues, investors and companies have, concurrently, directed their attention to Environmental, Social and Governance (ESG) matters and to Socially Responsible Investing (SRI).

Increasingly, major corporations are either carving out portions of their investor conferences or scheduling dedicated events to highlight the steps their businesses are taking to address these topics. The collective corporate spending on ESG has been tremendous, motivated by the belief that these efforts are important and will be heralded by employees, customers, and the communities in which these businesses operate. However, it is hard to believe that this spending is not also tied to some desire to tout their credentials to the investment community. It helps that ESG/SRI have also generated compelling returns in recent periods – principally by excluding exposure to the struggling fossil-fuel energy sector. Strong performance and clean imagery have helped drive tremendous inflows into ESG/SRI strategies, so it is not surprising to see more companies shifting to take advantage of the asset flows. The chart below from Morningstar shows sustainable funds gathered record inflows of just over $50 billion in 2020 across 369 funds, ending the year with $236 billion in assets.



Source: Morningstar. Data as of 12/31/2020.
Includes Sustainable Funds as defined in Sustainable Funds U.S. Landscape Report, Feb. 2020.
Includes funds that have been liquidated; does not include funds of funds.

Whatever the motivation, we expect this trend will become more prevalent in the coming years. This is in large part due to institutional investors, such as state pension plans, endowments, and mutual fund complexes (BlackRock, for example), showing an increased willingness to become more involved in their own ESG commitment. Historically, ESG/SRI investing took the approach of avoiding companies that do not meet certain sustainable or responsible criteria, but now powerful investors are starting to adopt a more active role[1].

This shift in landscape was clearly illustrated on a single day in late May when three distinct but equally dramatic events took place:

First – a small, relatively unknown hedge fund called Engine No. 1 won a contentious battle to replace four members of Exxon's Board of Directors by making its

[1] The Net Zero Asset Managers Initiative, for example, has committed to a goal of net zero greenhouse gas emissions by 2050 and investing in a manner aligned with this objective. Net Zero sports a membership of 128 asset management firms representing $43 trillion dollars in assets under management (AUM). Membership includes: Allianz, Blackrock, Fidelity, UBS, Wellington and many others and has grown from 50 companies representing just $9 trillion in AUM since December 2020.

case that the company needed new directors to help it thrive in an era of mounting climate urgency. It is extremely rare for large corporations to lose shareholder battles. Typically, the deck is stacked against outside agitators. Exxon spent $35 million on the proxy battle, highlighting the risk a loss would pose to their balance sheet and the sustainability of their dividend, which was already at risk. However, the stage had been set for Engine No. 1, following years of lackluster financial results, weak stock performance, and Exxon's unwillingness to confront global climate change.

A more notable, and unusual, feature of Engine No. 1's victory was its support from BlackRock and the state pension funds of California and New York. "Exxon and its Board need to further assess the company's strategy and board expertise against the possibility that demand for fossil fuels may decline rapidly in the coming decades," BlackRock wrote. "The company's current reluctance to do so presents a corporate governance issue that has the potential to undermine the company's long-term financial sustainability."

Second – A Dutch court ruled that Royal Dutch Shell had helped drive "dangerous climate change" and ordered the company to cut its CO_2 emissions by 45% by the end of 2030 from 2019 levels. One month earlier, Shell's shareholders had supported a company resolution to cut the carbon intensity of its products by 20% by 2030. However, the court did not find this commitment sufficient.

Third – Chevron, which held its own annual meeting that same day, faced a shareholder resolution that would force the company to cut its Scope 3 emissions - greenhouse gases released by the use of oil, gas, and other products that the company sells. Scope 3 emissions comprise 91% of Chevron's emissions and are very challenging for the company to reduce: Alternative energy and carbon credits do not satisfy the conditions, so mitigation will need to include reduced production or divestment of offending assets. The resolution passed with 61% of the vote, thereby compelling Chevron to a lower rate of profitability.

What makes these events so historically relevant is that shareholders are voting to force actions that will be financially negative, at least in the near-term, but superior in terms of other, environmental, priorities.

This follows the theme of our October 2019 Investment Perspectives (available on our website) where we discussed the influential Business Roundtable's decision to rewrite its Statement on Corporate Governance, previously described as the "principal objective of a business enterprise is to generate economic returns to its owners." The newly revised statement emphasizes that companies share a fundamental commitment to <u>all</u> stakeholders (customers, employees, suppliers, communities, and shareholders).

Businesses that choose to ignore some of their stakeholders may find they face powerful and worthy adversaries in a more active investor base. It remains to be seen whether fund managers, such as Engine Number 1, believe they can convince more institutional investors to reinstate Exxon or other fossil fuel companies into the "approved" universe of ESG compliant stocks. The increased demand for those equities, from ESG funds would boost their share prices, generating profits for the activists.

We would expect this trend to build upon its already considerable momentum in the years ahead. At Aureus, our focus on high quality companies with durable business models and excellent management teams has demonstrated a high overlap with ESG/SRI priorities and we believe positions us well for the shifting landscape.