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A Constructivist Approach to Sustainability

Our goal when investing is to create long-term value for our clients by allocating capital responsibly. That's why our engagement with the companies and governments whose securities we own is always with the intent to improve long-term investment performance for our clients. We believe constructive stewardship serves this aim well. Such stewardship is not just about the discharge of a duty. It is also about collaboration and understanding. We believe it gives us an analytical advantage and can act as a potential source of alpha generation.

In the investment industry, the prevailing wisdom seems to be that the stewardship decision is a binary one: You are either an activist or you are passive. We do not agree. There are many forms of effective stewardship. Academics from Oxford published a note on the four forms of stewardship: conservatism, opportunism, constructivism and activism. Their work informs our discussion of constructivism at MFS®.

What is constructivism?

The illustration below lays out the characteristics and tools that typify our constructivist approach.

CHARACTERISTICS

- Collaborative, open language
- Consensus-focused
- Focus on financial materiality
- Relationship-building
- Investor knows company
- Quality engagement

TOOLS

- Frequent outreach from both sides
- Active ownership (including voting)
- Private engagement
- Investor collaboration

Though we are constructivists, we aren't afraid of escalating when necessary. However, we believe that the best outcomes are more likely to be achieved through strong relationships and regular dialogue with the companies that we have chosen to invest in.

We are confident that our approach of long-term, constructive stewardship is the best way for us to fulfill our duty to clients. We are excited about our ability to create value in a way that is so complementary to our investment process. We will continue to practice

- outcome-focused engagement rooted in a deep knowledge of the company
- highly collaborative, long-term, persistent engagement
- holding companies accountable, not jumping immediately to exclusion or divestment or being overly aggressive or short-termist in our tactics

Constructivism in action

The examples below illustrate how MFS uses constructivism to gain a deeper understanding of labor risk in the supply chains of investee companies, engage on sustainability topics with fixed income issuers and facilitate more advanced discussions on the oil sands industry.

Addressing modern slavery risk with Samsung

We had several engagements with Samsung this year around its modern slavery risk management processes across Tier 1, 2 and 3 suppliers. We note that the company has taken significant action on sourcing critical minerals from modern slavery– free supply chains. The company has also been working with industry peers to try to make the ethical sourcing of critical minerals an industry practice such that competitors are not incentivized to compete on price or cost or source critical minerals from suppliers that are prone to poor labor management practices. We engaged with the company on developing and maintaining remediation mechanisms when incidents of modern slavery are identified. Samsung shared that it is a member of the Responsible Business Alliance (RBA) and has jointly conducted audits with the RBA.

We then had a further engagement with Samsung on its supply chain practices. This was a particularly constructive discussion as the company has become more open to discussing the topic, which is receiving more attention as supply chain regulations are tightening in the European Union and elsewhere and companies are increasingly being asked to prove that their suppliers do not violate modern slavery laws.

Our focus has been on the company's mobile phone business in particular as it is labor intensive and has a multitiered global supply chain. Samsung has developed better risk monitoring systems for suppliers over the past few years, but an additional issue to address is how upstream suppliers are incentivized through contractual terms that affect suppliers' compliance with the company's modern slavery policies. While Samsung conducts extensive labor audits, the audits in and of themselves tend to be focused on historical issues and may not address emerging pockets of labor risk in the supply chain.

We believe that Samsung is also exposed to supply chain labor risk in its sourcing of critical minerals such as nickel and cobalt. It has joined the Responsible Minerals Initiative (RMI) as a board member to establish industry best practice on securing conflict-free minerals. We believe this is a positive development that could indicate that the company views these issues to be both financially and operationally material. We are keen to explore this topic in further detail with them.

We note that Samsung's disclosure on risk management systems for supplier monitoring has also improved substantially over the past year and that the management team has been open to dialogue with investors, which we find encouraging.

Areas of future engagement will be focused on understanding how supply chain labor due diligence is conducted, remediation for noncompliant suppliers, the structuring of purchasing contracts and specific clauses around modern slavery.

Engagement in action: New Zealand sustainable bonds

In 2023 we had a sub-sovereign engagement meeting with the New Zealand Local Government Funding Agency (NZLGFA). The discussion focused heavily on environmental issues, both climate and non-climate, as well as the balance sheet, both loans and bonds. Overall, we feel developments are moving in a positive direction and, importantly, best practice was being shared and gaining traction in New Zealand's broad local government sector.

NZLGFA specializes in financing the local government sector, the primary purpose being to provide more efficient financing for local authorities and council-controlled organizations. LGFA was established to raise debt on behalf of local authorities on terms that are more favorable to them than if they raised the debt directly. Even though they don’t control the use of proceeds from its loans, LGFA is increasingly working with its council members on helping them with their environmental footprint and climate commitments.

The organization has made progress on its own sustainability commitments with the establishment of a Head of Sustainability and a Sustainability Committee (2021), zero carbon certification through offsets, creation and update of its materiality map, and creation of new lending products such as Green, Social and Sustainable (GSS) loans and Climate Action Loans (CALs). The organization also released various sustainability related policies and frameworks in the first half of 2023.

Periodic portfolio review around Suncor

One notable result to come from a portfolio review this year was discourse around Suncor, which lead to a presentation by one of our ESG analysts and the covering analysts at an energy meeting around oil sands. The objective of the presentation was to facilitate a more advanced discussion around owning oil sands, and potential implications from a climate standpoint.

We engaged with Suncor multiple times during the year. Suncor is part of the Pathways Alliance (PA) — an alliance of Canada’s six largest oil sands companies committed to reducing the environmental impact of oil sands development by collaborating to drive innovations and technologies through collaborative action.

The foundational project of the PA is Carbon Capture and Storage (CCS), a plan to reduce carbon dioxide emissions from oil sands operations. CCS captures carbon dioxide, CO2, before it is emitted from a facility and transports the CO2 to a secure location and stores it safely and permanently more underground. Our engagement was focused on investigating the progress of its Pathways CCS project and we were assured it was moving forward, still targeting Phase 1 in 2030. Suncor continues to build a clearer estimate of the costs of the first phase of Pathways, but no additional detail provided at this stage. We raised concerns over low transparency by the initiative and encouraged greater reporting going forward, which should cover activities, progress and estimated costs. We also encouraged Suncor to set a clearer target for its own operational emissions.

Oil sands are a material component of Suncor’s business, so understanding its undertaking of the Pathways CCS project, in our view, could have a material impact on its capex. This led to a broader conversation around owning Canadian oil sands. Over the past 20 years, Canadian oil sands companies have significantly reduced their upstream emissions, which shows progress in the right direction. As it stands, we believe Canada will support their decarbonization goals as these industries are a large source of the economy for the region and we will remain vigilant of the industry in case these companies start losing momentum on their aspirations.

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