Low carbon, high quality

Fundsmith topped the Funds Europe Asset Manager Carbon Impact Report 2024, achieving the lowest carbon footprint among 34 European asset managers and leading other ESG metrics. Thomas Boles explains the strategies driving their exceptional performance

INTERVIEW

Thomas Boles
Head of sustainability, Fundsmith

London-based investment manager Fundsmith credits its ESG numbers not to specific initiatives, but from identifying companies that sustain high returns on capital well above costs over a full cycle.

The firm last year reported the lowest carbon footprint (4.54 metric tons CO 2 e/€mn), weighted average carbon intensity (17.05 tCO 2 e/€mn assets under management) and highest Science-based Target Initiative allocation (86% of portfolio companies) figures among 34 European asset managers surveyed in the Funds Europe Asset Managers' Carbon Impact Report 2024.

Thomas Boles, head of sustainability, Fundsmith, decodes the secrets to the firm's sustainable strategy.

Quantifying "quality"

This approach by default excludes companies within highly cyclical industries or those with a high degree of exposure to volatile input costs, such as those reliant on commodities, such as oil, gas and mining, which are often too cyclical or exposed to volatile input costs to meet Fundsmith's quality criteria.

Instead, its portfolios lean toward technology, healthcare, and consumer goods, which tend to have lower carbon emissions and an inherent focus on innovation. "So far, we have found around 100 companies that meet our quality criteria," Boles adds.

Such "high-quality businesses," often consumer-facing, face greater scrutiny from regulators and the public and typically lead to minimising negative impacts while delivering positive environmental and societal outcomes, Boles points out.

This commitment is evident in Fundsmith's portfolio, where 86% of companies have set science-based targets, outpacing the MSCI All Country World Investable Market Index's 24%. Ensuring portfolio companies maintain their high-quality operations is key to keeping our carbon footprint low, shares Boles, adding that their innovation and operational efficiency improvements have driven progress.

This strategy seems to be delivering results. Fundsmith's largest portfolio, the Fundsmith Equity Fund, achieved a 23% reduction in total carbon emissions between 2019 and 2023.

"Actual emission reductions"

"We don't presume to run businesses better than their own management teams," says Boles. Instead, Fundsmith uses engagement as a tool to gain a deeper understanding of management's perspective on capital allocation, business strategy, or risks that may have long-term implications.

Reflecting the quality of the companies in the firm's portfolio, management teams are typically already aware of, and acting on, the risks identified or have determined that these risks are not material to the business.

Companies setting targets with the (SBTi), a corporate climate action organisation that enables companies and financial institutions play their part in combating the climate crisis, undergo a validation process by experts with far greater access to internal operations than an external investor could achieve. Fundsmith engages with companies to understand their decarbonisation strategies, ensuring alignment with its philosophy of trusting management while deepening insight into their sustainability initiatives.

"Some businesses already have very low emissions and don't see the value in undergoing a complex validation process. As long as they have a clear strategy and justification, we respect their approach," Boles shares. Real decarbonisation lies in "actual emission reductions", according to him. "We track emissions across all our portfolio companies," Boles says, adding that companies failing to reduce emissions, whether SBTi-aligned or not, are closely monitored and could prompt engagement if necessary.

Saying no to SDR

The UK's new Sustainability Disclosure Requirements (SDR) have prompted the firm to make a tough decision regarding its Fundsmith Sustainable Equity Fund. For the Funds Europe report, Fundsmith LLP reported 100% of its EU-domiciled funds categorised under Article 8. With the SDR labels approaching, how is the firm preparing to align?

According to Fundsmith, implementing these regulations would not require changes to the investment process for its Fundsmith Sustainable Equity Fund. Highlighting the challenges, Boles refers to former US President Ronald Reagan's remark: "The nine most terrifying words in the English language are: 'I'm from the government and I'm here to help."

He adds: "Change in the investment process for the Fundsmith Sustainable Equity Fund would be in the best interests of investors." As a result, Fundsmith has chosen not to adopt the Financial Conduct Authority's SDR requirements. This decision, however, necessitates removing the term »

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“sustainable” from the fund’s name. In due course, the fund will therefore be renamed the Fundsmith Stewardship Fund, Boles confirms.

"Commitments, not guarantees"

Managing the wider operational impact of "high quality companies" is key to reducing emissions, which play a large role given both the potential impacts of failing to mitigate climate change and the attention emissions are subject (ed) to both regulators and consumers. According to Boles: "The main challenge for scope 1 and 2 emissions is ensuring that our companies continue to manage their emissions to align with the requirement to keep global warming within 1.5°C by 2100 and achieve net zero emissions by 2050.”

The Fundsmith Equity Fund Sicav exemplifies this. “91% of the fund’s financed emissions (Scope 1 and 2) have 1.5°C-aligned reduction pathways validated by the SBTi, with a further 6% undergoing validation,” Boles shares. Additionally, 66% of the fund’s financed emissions have validated net zero targets, and 22% are in the process of committing to one.

However, Boles acknowledges that these are "commitments, not guarantees". Companies failing to meet targets they set themselves face the risk of backlash from consumers and regulators, which can impact returns, particularly as we head towards the 2030 (1.5°C-alignment) and 2050 (net zero) deadlines, highlights Boles.

Fundsmith has developed an in-house climate model to monitor companies’ emissions performance, comparing progress against 1.5°C and net-zero pathways. Using "historic emissions data", it projects if companies will meet 2030 targets. If risks of missing targets arise, Fundsmith engages to understand and encourage improvements.

Driving climate impact

Fundsmith's portfolios have small carbon footprints and strong SBTi alignment, highlights Boles. As of Q3 2024, nearly 90% of financed emissions are covered by SBTi-approved 1.5°C-aligned pathways, and 85% have validated or committed net-zero targets, shares Boles.

"Our focus is less on pushing ambitious climate targets and more on ensuring our companies maintain the high-quality traits that led to our investment in the first place," Boles says, emphasising effective capital allocation and long-term responsibility as key requirements.

Critics often argue that decarbonisation strategies can prioritise optics over substance, relying on divestment to show progress. Boles counters this view. “Divestment is never our first response to a company failing to meet its goals,” he shares. Instead, Fundsmith engages with businesses to understand their challenges and encourages realistic adjustments to their targets.

Offsets are not bad per se, he opines. When used appropriately, they address residual emissions unattainable through efficiency or renewables when guided by a clear strategy and high standards. Failure to address climate risks could affect a company’s ability to grow revenues, maintain margins, or sustain long-term returns due to increased regulations, taxes, or shifting consumer preferences. "Investing in companies that manage their external impact by reducing and managing negative externalities while producing positive ones is not a matter of optics for us; it is a key driver in how we select high-quality companies," says Boles.

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