Avoiding Turbulence: A Review of a Budget Airline Carrier

Responsible investment has been core to Newton’s investment approach since our inception in 1978, when we began actively voting on our clients’ shares. Since then, our responsible investment approach has grown to include environmental, social and governance (ESG) analysis, which is integrated across all our portfolios. This is done to identify risks and opportunities which have the potential to affect companies’ performance over the long term. As part of this process, all potential investments are subject to an ESG review before being formally recommended, and in early 2016 we conducted a review of a budget airline carrier as one of our analysts wanted to recommend it to the house.

What Were the Red Flags?

At the time of investment consideration, a number of governance concerns were identified in this airline. The board had very few independent members, at a level which did not meet UK Corporate Governance Code standards. Its membership was almost exclusively men, and two-thirds of the board was comprised of one nationality, despite this being a global company; to us, this demonstrated a lack of diversity. In recent years, a light has been shone onto this issue as an increasing amount of research suggests that a lack of diversity can negatively affect a company’s financial performance.

We were also concerned that a board lacking independence and diversity would not offer sufficient challenge to the company’s CEO.

Remuneration is an issue that has attracted considerable investor attention in recent years. As an investor, we are encouraged by transparent disclosures by companies and evidence that remuneration is used to incentivize long-term, strategic thinking. However, the airline disclosed little information in relation to executives’ bonuses or the long-term components of their pay, raising questions on how they were being incentivized to run the company over the short and long term.

Employee relations were also identified as a potentially material issue following extensive labor disruptions.

The airline has a seasonal schedule whereby the number of flights is increased or decreased owing to varying demand throughout the year. As a result of this seasonality, the company does not ensure that employee compensation agreements remain constant across this time. On the upside, this has led to lower labor costs and lower fares, benefiting both the company and investors; however, on the downside, this leads to an unhappy workforce which feels increasingly unable to engage with management.
Tensions have been further inflamed by failed union negotiations across multiple European countries, where unionization levels are high and company engagement is commonplace. As a result, we were aware of a potential risk to the company’s bottom line. Customer demand for low-budget, short-haul flights is known for its flexibility – customers are likely to pick the cheapest and most convenient options for their journey. This can lead to considerable surges and falls in demand. This means that well-timed industrial action can cause major disruptions.

This risk materialized between 2014 and 2016, when, following increased media coverage, the airline saw strikes in a number of countries, and received a large fine over labor law violations. The company was also forced to cancel a significant number of flights, affecting hundreds of thousands of passengers.

**How Do We Integrate ESG Research Into Investment Decisions?**

After discussing these concerns with our sector analyst, our ESG research was circulated to the whole investment team. This flagged our concerns to the portfolio managers and made sure that this analysis formed part of the overall investment decision. We know that some portfolio managers chose not to invest in the company based on the ESG quality review.

This example demonstrates how a company’s handling of ESG risks can negatively affect its financial performance. It also highlights why we undertake ESG analysis before recommending all companies for investment.
IMPORTANT INFORMATION

Investors should consider the investment objectives, risks, charges, and expenses of a mutual fund carefully before investing. Contact a financial advisor or visit im.bnymellon.com to obtain a prospectus, or summary prospectus, that contains this and other information about the fund, and read it carefully before investing.

All investments involve risk including loss of principal. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Asset allocation and diversification cannot ensure a profit or protect against loss.

Risks:

Bonds are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees.

Currencies are can decline in value relative to a local currency, or, in the case of hedged positions, the local currency will decline relative to the currency being hedged. These risks may increase fund volatility.

Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

Impact investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating. Recent market risks include pandemic risks related to COVID-19. The effects of COVID-19 have contributed to increased volatility in global markets and will likely affect certain countries, companies, industries and market sectors more dramatically than others. To the extent the fund may overweight its investments in certain countries, companies, industries or market sectors, such positions will increase the fund's exposure to risk of loss from adverse developments affecting those countries, companies, industries or sectors.

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