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# THE ABCs OF ESG

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## Why we believe environmental, social and governance factors are critical to investment decision-making, regardless of ethics or values.

When you first hear about ESG or sustainable investing, what comes to mind? Millennials and their avocado toast? Scions of wealthy families who are more concerned with saving the world than making returns? Regulation?

What about the vast bulk of investors who need their investment to deliver solid financial results in order to meet their investment goals?

Let's start with the basics. What does ESG investing mean? The letters 'ESG' stand for environmental, social and governance respectively. They broadly refer to the non-strictly financial considerations which may be taken into account when analysing a security.

They attempt to measure things like carbon footprints, the diversity of boards and executive teams, and the protection of minority shareholder rights. Some people position ESG investing as a pathway towards better returns, while others position it as a way to save the planet, or as a combination of both.

From our capitalist perspective, ESG investing is an essential part of the 'mosaic' theory, which entails gathering all available information about an issuer to help determine the value of its securities. ESG considerations are important factors which, by themselves, don't determine that value, but which, when combined with financial data, provide key insights into an issuer's (company or other entity) dynamics. Economists call these factors 'externalities', and they can have a critical impact on the future earnings of a company. Just take a look at some recent examples.

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# THE ENVIRONMENTAL IMPACT

Concern about the environment is growing, and regulators are taking notice. The impact of a major oil spill is reported to have cost one company $62 billion once all of the various claims against it are settled. More recently we have witnessed the diesel emissions scandal, which may cost a car manufacturer upwards of $46 billion in the US alone. These negative factors have clearly affected the financial results of these (and other) firms, and, importantly, with the change in the regulatory environment they are likely to grow in influence.

Whatever your views on climate change, a wide swathe of related regulatory changes, penalties and taxes is set to come into effect worldwide, and companies must take these into account. The Carbon Disclosure Project estimates the impact of these negative impacts on corporate earnings to be over $1 trillion. This eye-catching number is not whipped up by some well-meaning technocrat or environmental cause; it is the number being reported by the companies themselves. On the flip side, these companies have identified $2.1 trillion of positive commercial benefits that will be presented by climate change. These impacts are clearly material, no matter what your views on climate change are.


Water polluted by copper mining at Geamana lake, Romania

# WHY CULTURE MATTERS

Similarly, the social impact of a company's behaviour is increasingly being felt on the bottom line. Sexual harassment and gender discrimination accusations have roiled the shares of several household names, with senior leaders or key talent having to step down to address claims of impropriety. Multiple claims of this type can represent something indicative of a company's culture, which in turn can hamper both its brand and share price.

As with environmental considerations, there are positive factors to look for in relation to gender balance. In 2014, the Academy of Management published meta-analysis of all the diversity studies of boards.[1] It found that diverse boards produce superior accounting returns (although no solid evidence for improved shareholder returns), and that this effect was more pronounced in environments where the gender pay gap was less pronounced.

# GOOD GOVERNANCE IS CRITICAL

Good governance is a critical part of the analysis of any company. The effectiveness of a board and executive management team to set the strategic direction and the culture of the organisation are crucial to a firm's future success. In developed markets, this is often taken as a given (although there are still numerous cases where there is scope for improvement in governance). However, in the emerging markets, this becomes even more important where state actors may, either explicitly or implicitly, be influencing the strategic direction of a company in a way that doesn't maximise shareholder returns. In addition to this, there is frequently less of a legal framework to ensure the alignment of the interests of a majority shareholder (often the state or a state-owned entity) with those of the minority shareholder (the outside investor). This is a critical factor to monitor if investors are to avoid the pitfalls of investing in markets where the rule of law is not robust.

# NOT ALL ESG INVESTING IS THE SAME

How to do ESG investing is as important as why to do it in the first place. Incorporating how you look at non-financial factors in the 'mosaic' can improve your understanding of a company's prospects. Over 70% of those focused on ESG investing use 'exclusions' as the basis for constructing a portfolio. Such negative screening can have the opposite of the desired effect by making screened-out securities better investments. By divesting

1 https://journals.aom.org/doi/abs/10.5465/amj.2013.0319

companies purely on the basis of what sector or region they are in has the effect of pushing down the share price, and thus making future expected returns higher.

Similarly, investing in companies with only 'high' ESG scores has not been shown to add value. Why? Because companies that are known to score well on ESG measures usually have this information already embedded into the price of the shares. Often there is a correlation between sectors and ESG scores (technology and health care, for example, tending to have higher scores), and it is important not to conflate the various drivers of share prices. Even worse, mechanistically investing in companies with high scores can have the opposite effect of the one described earlier. It bids up the price of the security relative to its peers, thus lowering future returns. Investors who blend their ethical and moral judgements into their financial decision-making do so at the risk of sacrificing future returns.

# MAKING SENSE OF THE DATA

It would be remiss not to point out that incorporating environmental, social, and governance factors into investment decision making is in its relative infancy. Traditional financial analysis has been going on for almost a century, and there is a wealth of standardised data to support those decisions. This is not the case for ESG data which, where it exists, can be patchy and sometime contradictory. This argues for careful active interpretation of information and its potential positive or negative implications for a share price.

A more robust approach requires the incorporation of *expected* information and the judgemental incorporation of the ESG information into the investment decision. This is an area where there is considerably less efficiency than in conventional financial data (owing to the lack of ESG data described above), and there is consequently more potential for active asset managers to understand impact on share prices over time. Indeed, another concern with understanding the impact of ESG factors is the time horizon over which they unfold. While negative factors (such as oil spills and child-labour scandals) can cause a short and sharp correction in a share price once in the public domain, positive factors (such as improving governance or supply chains) can take years to play out. It is precisely for this reason that we believe investment managers who have already established their ESG credentials, and who are actively engaging with the companies they invest in to help improve their ESG footprint over time, can leverage a potential competitive advantage over those that don't.

In summary, putting aside one's ethics or values, there is a robust case that environmental, social and governance factors should be taken into consideration when evaluating a security. Not only can such factors form a critical part of the mosaic of decision-making, but, given the lack of informational efficiency in them, they may also provide a rich vein for active managers to exploit for competitive advantage. As regulations change globally and affect companies and their supply chains, the evaluation of ESG criteria is likely to become even more important in evaluating the potential impact on share prices.

### Want to find out more?

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