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The Challenging World of Environmental, Social and Governance Investing

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There is, without question, a huge demand around the world for investment products that take into account environmental, social and governance (ESG) concerns. Data from Morningstar show that the assets of sustainable funds tripled from the end of 2018 to mid-2021 to $2.3tn. In the run up to the Cop 26 United Nations conference on climate change investors' focus is very much on the environmental component of the ESG agenda as global policymakers seek to accelerate the transition to a low carbon world.

The big question is whether the managers of self-proclaimed sustainable funds such as ESG mutual funds and exchange traded funds are delivering on the ESG promise to investors.

There are grounds for scepticism. For a start Tariq Fancy, the former chief investment officer for sustainable investment at BlackRock, the world's biggest fund management group, has publicly denounced these funds as a marketing gimmick, noting that ESG products carry higher fees than non-ESG funds. He now believes that his work at BlackRock led the world into 'a dangerous mirage' and that claims made for ESG investing in delivering higher returns are spurious.

Equally striking is that Eiji Hirano, former chairman of Japan's Government Pension Investment Fund, the world's biggest pension fund and a pioneer in sustainable investment, has warned of a bubble in ESG investing. In an interview with Bloomberg in June he called for the GPIF to think about how to analyse whether ESG was really profitable, as well as how to evaluate and standardise ESG.

At the same time the whole area is beset with endemic methodological problems. At the company level there is extraordinary fragmentation in reporting standards on ESG issues and while initiatives are afoot to move towards a more coherent international framework progress is painfully slow.

This matters because the risks to the global corporate sector are huge. Part of the difficulty is that the scoring system of capitalism is flawed in relation to externalities – that is, companies' bottom line does not include costs such as the environmental damage they inflict on wider society. These costs can be potentially life threatening for businesses.

Harvard Business School has been working on an Impact-Weighted Accounts Project which finds that many companies are creating environmental costs that exceed their total profits. Of the 1,694 companies covered, the study found that 252 firms (15 per cent) of companies would lose all profitability if external impact costs were included, and 543 more firms (32 per cent) would see profitability reduced by 25 per cent or more.

It seems inevitable that governments will resort to regulation to put such costs back into corporate financial accounts. This will result in dramatic impairments to the value of fossil fuel-sensitive assets in company balance sheets as well as reduced profits.

Companies are in a position to provide hard data about the cost of shifting their business models onto a more sustainable basis and to indicate how far they go in trying to meet the UN sustainable development goals. Yet recent survey evidence has found that only around a fifth of publicly traded companies in the Forbes Global 2000 list have made any form of commitment to net zero greenhouse gas emissions.

Note, too, that a recent survey of 400 directors by consultant EY found that more than half of directors surveyed said they were considering ESG issues only because compliance, disclosure obligations and shareholder pressure compelled them to do so. Only about a third said their company had controls in place around the collection and disclosure of material ESG information.

The picture is further complicated by flawed incentive structures. A recent submission by FutureZero and Close Group Consulting to the US Securities and Exchange Commission pointed out that the greenhouse gas or carbon metrics and targets in corporate proxy statements were used less than 10% of the time in executive incentive design for listed companies, while the longest performance period for long term incentive plans was just three years or less for 90 per cent of listed companies – a clear disconnect in time horizon with the 2050 UN targets.

The consultants added that these incentive plans had been overwhelmingly voted "FOR" and approved by most of the major asset owners (including the largest US and Canadian pension funds) and the world's largest asset managers in their proxy and "say on pay" voting.

It follows that these incentive structures are locking in high carbon business models, thereby militating against the goal of net zero emissions.

Looked at from the fund manager's perspective, this all leads to huge uncertainty about future returns. A report by pension consultants Mercer, for example, has projected that the average annual returns from the coal sector could fall by anywhere between 18 per cent and 74 per cent over the period 2015 to 2050. Meantime the energy renewables sector could see average annual returns increase by between six per cent and 54 per cent over the same period.

Against that background fund managers have placed considerable reliance on ESG ratings providers. Yet the ratings are the product of widely varying methodologies which are, in the end, subjective. To give just one blatant example of the weird outcomes that can result, rating firm MSCI's ESG system currently assigns ExxonMobil a BBB rating (high average) while drugmaker Moderna has a BB rating (between average and high average).

ExxonMobil has denied climate change science for decades while Moderna is a global leader in providing Covid-19 vaccines. Given that the fossil fuel sector contributes to millions of premature deaths annually while Covid-19 vaccinations prevent death the relative impacts of these two companies on human wellbeing make the MSCI rating seems bizarre, especially when a fund manager's decision to sell Moderna and buy ExxonMobil would improve its ESG rating.

When it comes to the "S" part of ESG there is no agreed definition of what it covers. In practice the ground includes labour standards, human rights, gender and diversity policies, health and safety, community relations and much else besides. Subjectivity at ratings providers is particularly acute in this category. A recent paper by economists MIT Sloan School looked at inconsistencies across six different ESG ratings providers, namely KLD, Sustainalytics, Vigeo Eiris, RobecoSAM, Asset4 and MSCI. They found huge measurement divergences, especially on human rights and product safety.

Also noteworthy is a 2020 study by ShareAction, a group promoting responsible investment, which found that 84 per cent of 75 of the world's largest asset managers did not have a policy excluding bonds issued by countries involved in human rights violations.

As for "G" there is a growing recognition among investors that good governance is central to value creation and perhaps more importantly bad governance is often a prime cause of value destruction. This perception has, of course, been an important part of Abenomics, leading to the introduction of corporate governance and stewardship codes in Japan. Yet there continue to be corporate governance scandals in the major markets, while in Japan many companies continue to hoard cash rather than distribute it to shareholders.

The practicalities, then, are daunting. And there remains the wider question of whether ESG investing can deliver higher returns than the overall market. There is no decisive evidence that it does. And while some studies do claim to show above market returns for ESG it is possible that this reflects the weight of money flowing into the sector.

That said, there is the common sense case that companies which abuse the environment, treat staff poorly or damage the fabric of society will, over time, be regulated out of profitability or abandoned by their customers. Likewise that an ESG approach could mitigate the hit to performance that may result from a regulatory shock such as a move to much tougher carbon pricing. Many, perhaps most, institutional investors believe that decarbonisation is not priced into markets, in which case ESG strategies are essential for mitigating climate risk and seeking opportunities in innovation.

It is also clear that shareholder activism is beginning to pay off, most notably at ExxonMobil where activism succeeded this year in re-shuffling the board. Collective institutional investor pressure through bodies such as Climate Action 100+ which targets the world's 100 most heavy corporate polluters is also having an impact. Such action makes particular sense for the biggest global investors because the externalities generated by one company in their portfolio impose costs on all the others. Forcing investee companies to move to less carbon intensive business models is a clear win for the total portfolio. Note, too, that academics from IESE Business School have found convincing evidence that pressure by the Big Three global fund managers – BlackRock, Vanguard and State Street – has led to progressive reductions in carbon emissions by big companies with currently high CO2 emissions.

But for such pressure to have a significant and enduring impact governments and regulators would need to adopt credibly threatening positions on carbon reduction to ensure that fossil fuel intensive assets are not simply shuffled by listed companies into the hands of insouciant private equity or state owned entities in emerging markets.

In the final analysis decarbonisation requires the accelerated obsolescence of a large chunk of the global capital stock and the reallocation of capital to less fossil fuel intensive investment. Without a more aggressive approach to carbon pricing, which would help reinforce investors' efforts, this is unlikely to happen. The political obstacles to this are immense but the stakes, in terms of human lives and wellbeing, are of earth shattering importance, not least at Cop 26.

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