Why choose Environmental, Social and Governance (ESG) investing? – Part 1

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In the first in our series on ESG investing, we ask whether this is a sustainable shift in investment practice and priorities that can't be ignored or a marketing exercise that can.

The famous Friedman assertion that "the business of business is business" is being challenged. The US Business Roundtable now says that a company's purpose is the interests of customers, workers and communities - not just shareholders, as Friedman asserted. The Network for Greening the Financial System, a group of 51 central banks and supervisors, analyses potential losses to financial systems from things like climate change. The Bank of England expects banks to have thought about it, while Christine Lagarde, the President of the ECB, said that its monetary policy should take it into account. Others, including polluting countries, talk about consequent shifts in aggregate demand and monetary policy.

Investors, too, increasingly demand that their portfolios take into account environmental and social factors and have high standards of corporate governance. Consumers, voting only with their wallets, have changed how firms and their suppliers source materials and treat workers. Clearly investors, who can sell their holdings, vote directors out and lean on management to do thing differently, can clearly do much more.

But most investors also must meet return targets, which pension and mutual funds, who dominate many share registers, rely on to fund retirement income and keep schools, research institutions, hospitals and other services, operating. Knowing that your retirement fund is not supporting child labour or poisoning pristine waterways is of course reassuring, but it doesn't help meet your own financial obligations.

Can you have your forest and log it too?

Can ESG investing actually enhance financial performance or is it always going to be, in the long term, a drag on it? There are good reasons why ESG investments might out-perform other investments; and there are good reasons why they may not.

Whether or not you think it a marketing exercise, ESG assets are likely to be in demand for some time to come, as millennials, who are especially keen on things ESG, start investing. This has two important implications. The first is that the weight of their new money may drive potential capital appreciation, even if assets' profitability is unchanged. The other is that they are naturally more interested in long-term outcomes than short-term cash-flows.

ESG assets themselves tend to have long pay-off, and therefore investment, horizons. The ESG effect could thus persist. To get an idea of how long, recall that Fama and French first identified the Value-Growth anomaly in the 1970s, yet it took over 40 years to “correct” the mispricing.

You can also argue that firms engaged in forward-looking industries are themselves likely to be forward-looking, socially-responsible and well governed, hence less likely to suffer corporate catastrophes like Union Carbide at Bhopal, Enron in Rajasthan, Exxon in Alaska, and more recently, Boeing and Volkswagen. Avoiding such costly events can add significantly to returns and reduce perceived riskiness.

As the demand for environmentally responsible and sustainable consumption inevitably increases, some polluting assets may find themselves “stranded”. For example, a shift away from coal may leave some coal mines unprofitable, eventually forcing costly closure and write-downs. The mere risk of this happening can raise the cost of capital for such projects and their parent firms.

Yet isn’t this ambiguity and uncertainty in markets good for talented managers? They can select assets with methods including ESG which may not be followed by less talented investors?

Basic portfolio theory tells us that the more investable assets there are to choose from, the more scope for the portfolio to add value, other things being equal. Constraining your portfolio to ESG factors or filtering out non-ESG assets could thus be a drag on your return to risk balance, so your investment will either return less, be more volatile, or both.

Credit ratings carry another lesson: that highly-rated assets can generally only go one way - down the ratings ladder - limiting their potential to outperform other assets. Could the same thing be true of assets with high ESG ratings? We already see the significant demand from investors for Green Bonds which mean that they return less so that ESG may already be either priced to perfection or even possibly overvalued.

Whether you go with the strong ESG momentum or use this as an opportunity to accumulate some unfashionable, non-ESG bargains, you need to keep an eye on both ESG and fundamental profitability barometers. These remain necessary to meet your return objectives as well as maintain high standards of environmental, social responsibility and governance.

The next blog in our series looks below the ESG label to see where the pitfalls can be.

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