Why choose Environmental, Social and Governance (ESG) investing? – Part 2

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In our previous blog, we found that ESG investing is an increasing focus which is becoming embedded into investor requirements. In this second part of our ESG blog, we look at how ESG factors and funds are selected. We find it not as straightforward as it may seem.

How do you select assets or funds to include in your ESG portfolio? The most obvious way is to invest only in industries and assets that meet your ESG standards, while avoiding those that don't. You can do this either by filtering in good stocks, filtering out bad stocks, applying some kind of score or rating for each asset, or some combination of these. None is problem-free.

Filtering can have unintended consequences, as the managers of a socially-responsible, "ethical" fund found a few years ago when it emerged that their attempted embargoing of pornography had filtered out the entire telecoms sector! In fact, filtering has plenty of pitfalls, whichever technique you use.

For example, an obvious way to filter or score assets, is according to industry classification. But firms adapt and change their businesses over time. Remember Nokia - which went from forestry to consumer mobile devices to telecoms infrastructure. GE was, for a long time, classified as electrical goods, even though it made more money from financial services. Designated classifications can be slow to catch up.

Looking below the label, you may find a firm that, say, builds and manages wind farms, but sources its components from third country suppliers that employ child labour, treats its own employees badly and is itself poorly managed or riddled with conflicts of interest. Equally, an oil firm may be well-governed, treat its employees well and clean up after itself. Tesla has historically demonstrated how to tick the E box, while getting the G badly awry.

How do you filter or score diversified firms with operations in several sectors? Say a firm derives 30% of its profits from wind farms, which you support, and 70% coal production, which you don't. You could invest only 30% of what you might have otherwise, but if it is reinvesting more in its coal business, then you would worry that your reduced investment were subsidising coal. And do you even know what those proportions are? Most jurisdictions do not require profits to be reported by line of business, and those that do, only with a lag.

How will your performance be affected? Other things being equal, the more assets you have to choose from, the better your chances of good financial results: filtering narrows your scope for good returns. You might get better results, both financial and ESG, by engaging with firms to clean up their act.

If you are investing in an ESG multi-strategy fund, you of course, rely on its managers not only to select and monitor the best-performing ESG stocks, but to ensure that they themselves adhere to high standards. Your due diligence might ask if the firm's waste is recycled, if all international travel is justified, or could more use be made of video-conferencing? Are its offices close to public transport, does it facilitate work-from-home or otherwise reduce employees' car-use? A firm that promotes a socially-responsible fund ideally treats its own employees and suppliers well.

Many investors find that it makes sense to harness the work of independent research specialists to provide scores that can fit neatly into portfolio selection processes. Edgehaven is an early adopter of these new ESG services and uses a select number of providers since there is currently no standard approach. However, in private markets, scarcity of information makes it difficult for researchers to make high quality judgements for all investments. Very often a listed sector proxy is used for private companies and in our experience, this can be highly misleading.

Typically, researchers obtain ratings by attaching a score to each of a number of ESG "factors" and assigning a weight to each factor, which they add up to give a score for the private firm or fund. You need to watch out for three things:

Rankings and scores inevitably push firms and funds into "bands", much as credit ratings do. Cut-off points can be arbitrary. For example, a firm ranked, say, at the bottom end of BBB, may more resemble another at the top end of BB, than others ranked BBB. Lumping the two BBB-ranked firms together may lead you to over-price one and under-price the other. Plus, in private markets, firms typically use a listed sector shortcut as well rather than looking at the private company's practises.

Ratings can be easy to arbitrage and game. Firms may tweak their operations to tick the right ESG boxes in the agencies' check-list evaluations, without necessarily changing how they do things. Publicly announcing a brilliant ESG initiative can be a far cry from expertly implementing it successfully. This "greenwashing" effect to window-dress ESG ratings has been frequently reported in the media.

Once a firm achieves a high ESG ranking, subsequently re-ranking can only be negative. There is only one way from the best rating, and firms must work hard to maintain ESG primacy.

Done well, sustainable investing can enhance returns and help avoid the worst outcomes, but poor selection and execution can lead you to over-pay for fashionable yet mediocre assets that are bound to deteriorate.

Many investors view ESG investing as a sustained investment imperative or as an opportunity to invest in valuable but unfashionable assets at bargain prices. Nevertheless, the complexity that it adds at implementation stage also presents an opportunity for astute investors with skilled advisers to achieve attractive long-term performance.

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