ESG Investing Is Hard To Do.

I had discussed ESG in this previous article entitled: ESG: Externalities Unpriced, in an attempt to encourage a more rigorous analysis of ESG, arguing that ESG leads to better investment results due to a more comprehensive understanding of the factors surrounding a business so that these factors can be integrated into both risk mitigation as well as a business origination. This provides a more comprehensive picture for management in terms of control, and for shareholder in terms of allocation and governance.

Even with these ideals in mind, ESG is more complicated than I'd thought. And here we are not even talking about greenwashing but assuming good faith efforts in the pursuit of more sustainable business practices.

Purpose. The purpose of business is profit. It is practically intractable to maximize two measures at the same time unless we establish a strong dependence between the two. For a business to maximize profits and social or environmental impact is simply too difficult to do. A business should profit maximise. The reason ESG is important to a profit maximiser is that it increases the information available to management in their strategic planning. The objective horizon is important. Short term gains can be made through irresponsible behaviour which has long term costs. It is therefore important that management is incentivised to maximize value over sufficiently long time frames. Attempts to maximize measures other than or in addition to profit, present management with confusing mandates which risk management failure. This is an unnecessary risk and should be avoided. Businesses are expected to make money, and to avoid irresponsible practices while they go about it.

Identifying and prioritizing ESG factors. As ESG is a relatively new concept, the availability and quality of data is an issue. Business managers need to identify all factors which can impact financial performance and to determine the importance and priority of such factors to the business. The importance of a factor can vary over time and can correlate with other factors. For example, the climate impact of a firm can vary over time as its product line evolves. An fashion business that pivots from leather shoes to canvas trainers may need to address its water consumption or its use of recycled plastics. The social profile of a firm also varies with the evolution of its client base. As European fashion courted Chinese demand, witness Dolce and Gabanna’s epic fail in respecting the cultural sensitivities of its target audience in late 2018. Managers need to understand the risks and opportunities to their business more holistically, and ESG provides such a completion to the traditional financial metrics. Similarly, investors need to understand the scope and priority of the ESG measures managers focus on both to understand the business better, and to benchmark the performance of management.

The ESG label implies a systematic focus which sometimes obscures the bigger picture. ESG appraisals often focus on internal processes and appraises the firm in isolation rather than its role as a part of an ecosystem. *A firm’s impact on society and environment begins before it acquires raw materials and persists long after it sells its product.* The sustainability and financial fate of a firm is impacted by its sourcing decisions and its legacy. Using electric vehicles as an example, the non financial impact of battery manufacture often includes the consumption of massive quantities of water, in countries where water is inefficiently priced, and the use of exploitative labour practices to further under-state the true cost. The cost of recycling, decommissioning and otherwise disposing of lithium based batteries can potentially be put back to manufacturers someday, directly, or indirectly if buyers are charged decommissioning costs. Firms are best appraised within their ecosystem, and not just within their competitors and their immediate supply chain. Impact investing, which is distinct from ESG investing, has tools for measuring the impact of a business within its ecosystem, tools which it may be useful for ESG investors to borrow.

ESG heightens the trade-off between subjectivity and objectivity. In any form of decision making, such as in the field of investments, there is always a trade-off between a subjective versus an objective approach. The ESG investing industry is thus bifurcated. One camp prefers a systematic and transparent approach which is rooted in exclusions and inclusions based on objective ESG metrics. The other approach integrates ESG factors into traditional discretionary securities analysis.

The systematic approach is decisive, auditable and transparent. However, it is susceptible to type I errors, i.e. rejecting acceptable candidates. The integrated approach is less susceptible to type I errors, is not more susceptible to type II errors, that is, accepting an unacceptable firm, but is less transparent, less systematic and less decisive, often leading to more indeterminate classifications, that is, neither accepting nor rejecting a candidate. On the one hand, a systematic approach makes the investment problem more tractable while on the other the discretionary approach makes it more purposeful. Some investors take the view that their capital should animate social, environmental and corporate governance improvement and so favour the integrated approach. This necessitates the use of some impact metrics to validate the thesis. For most investors, some combination of the systematic and the discretionary approaches is useful. There will be type I and II errors but there are sufficient investment opportunities that some level of waste is acceptable.

Measuring impact is hard to do. If one is borrowing impact metric measurement to augment their ESG program, it is important to be able to measure this impact. This is doubly important since our interest is ultimately not the impact itself, but its information content as regards the financial outcome. How do we know that the impact metric we are interested in has real impact on financial outcome, whether as a driver or a risk mitigant? This requires good econometrics. It also brings to the fore the problem of gestation. The investment community is focused on measurement, which is understandable, but often is unaware of the gestation periods between decision and result. In public markets, the availability of daily prices encourages very short-term expectations. Private markets dearth of pricing data encourages longer term expectations. In the area of non-financial impact, the lag between action and result can be considerable. In climate change for example, the consequences of current behaviour can manifest over decades. The desire for better and higher frequency data can encourage short termism. Also, the complex relationships in non-financial metrics require careful model specification, a problem compounded by the financial industry having a patchy track record in theoretical rigour. Impact measurement is an area ripe for further research.

Common sense is not so common. There is sometimes a lack of common sense in investment management. The narrow focus on profit can lead to tunnel vision. Complexity replaces simplicity. Conventions which may be irrational persist due to investor inertia. Many ESG factors and considerations are a matter of common sense and not some specialized analytical lens. Many impact goals would evidently reward an investor seeking to address them since they address a present need. If there are persistent gaps and adverse outcomes, they are often due to market failures. Solving these market failures is more efficient than addressing the gaps and adverse outcomes. In fact, such gaps and micro failures can be outright profit opportunities to private capital willing to provide a solution. This raises the question faced by many a for-profit organization. Fix the problem once and for all, or provide analgesics for ever, bringing us back to the question of purpose.