ESG: Externalities Unpriced

ESG is gaining awareness among investors. To date there are some 120 ESG ETFs with 11 billion USD of assets under management. SRI investing is expanding and currently totals 12 trillion USD in assets. Why might ESG investing be important and useful from an investment perspective, that is apart from doing good? Asset managers responsible for some 60 trillion USD of assets, roughly 50% of the global institutional asset base, have signed up to the UN Principles of Responsible Investing. While they may not explicitly manage assets to stated ESG criteria, they are at least aware of the PRI standards and incorporate the practices in some form.

Sustainability is an all-encompassing concept which takes into account factors economic, environmental and social. Economic sustainability is self-evident. Business has to be profitable and a going concern. It cannot act in ways that threaten its long term status as a going concern. Robust corporate governance is necessary to align the interests of all stakeholders and manage conflicts of interests. Efficiency and robustness needs to be balanced. The balance of power between the executive and the board has been an area of recent focus. The separation of duties has value in providing checks and balances. Employee relations are equally important as a factor in attracting talent, retaining it and enabling it.

On the environmental front, climate change awareness is important, if nothing else as a factor in risk management. Companies which ignore this aspect are at risk of being unprepared for the implications of climate change. Seasonality changes impact agriculture, transport and consumer behaviour. Increased unpredictability places physical assets and infrastructure at risk. Insurance costs rise and fall with the occurrence of natural disasters. Failure to at least be aware and apprised of climate risk is a weakness in risk management within a business.

On the social front, human rights are not only a moral factor, they are an important risk factor. The health and welfare of local communities, developed or developing, can have important implications for supply chains, and the commercial ecosystem of consumers, employees, and shareholders. Consumer protection and welfare is important. Firms may be tempted to optimize shareholder value at the exclusion of all other stakeholders, but the detriment of the customer is surely self-defeating and a significant risk while the detriment of employees is failure to manage an important input factor.

More than all these rather pragmatic and self-serving considerations, businesses clearly do not operate in a vacuum. Their actions and decisions have implications which reach beyond their narrow industries, supply chains and markets. Society and the global economy is an ecosystem which thrives on balance. Imbalances are corrected over time, gradually or suddenly and the greater the imbalance the greater, and often the more sudden the adjustment.

One of the more difficult hurdles that ESG will have to surmount is the misalignment between individual and collective objectives, commonly referred to as the tragedy of the commons, solutions to which are hard to find.

It is important to realize that ESG is not philanthropy, not does it involve sacrificing returns in return for altruistic objectives. In fact, ESG investing is an extension of risk management above and beyond the traditional quantitative metrics such as VaR and volatility, or default and recovery. The adoption or integration of ESG principles of investing should therefore yield better results, not worse. The simplistic view that ESG compliance results in poorer corporate performance is outmoded. Externalities are priced in over time and businesses which neglect including these factors in their production functions are assuming additional risk. As for investors, the pricing of these externalities simply results in a more complete characterization of a business which surely leads to better decision making, which in turn yields better investment results.