ESG: The Good, The Bad, and The Ugly

Asset owners considering the use of ESG factors need to fully understand what these factors are but most importantly how they are derived. There is no common reporting standard in ESG, and there is a good reason for this as, unlike GAAP in accounting, one size does not fit all.

Perversely, adopting ESG metrics as is can open the owner to non-financial and reputational risks.

Not only is ESG reporting expensive but certain elements are highly subjective which gives those with the right budget the ability to score very well. Such a screen would preclude holdings in valid small to medium sized companies where most of the performance comes from, and there is nothing that kills a portfolio quicker than concentration risk.

Reputational risks arise when a high scoring company engages in unethical practices. The subsequent impact is both financial but also reputational as the repercussions for a public asset owner are played out on an open stage. For example, a large Korean steel manufacturer which despite very high reported ESG factors is on many exclusionary lists due to its use of child labour in one of its subsidiaries.

Such news would be highly damaging to the owner irrespective of the size and reputation of the 3rd party manager.

Factors such as energy use, pollution, and conservation are not always reported. Sometimes this is simply down to cost. An easy example of this are smaller Water Utilities in the US who have theoretically very high scores but do not report. Industrial companies by their very nature tend to score badly as their manufacturing process require both energy and water but produce waste. This is true even if their products are at the core of renewable energy and energy efficiency. Here we need to choose companies on more than simple emission factors, we need to analyse their emissions and efficiency compared to their peers to determine good environmental processes.

How does this affect the LGPSs in particular? By their very nature Long Only funds have a positive economic bias which provide no protection in difficult times, this is especially problematic with public sector funds where the safety net is built by taxation, which again has a positive economic bias. Double Jeopardy. Additionally, artificially low rate environments create multiple dangers, from negating Risk Parity strategies to over inflating the value of Real Estate.

Collectively the UK pension system's exposure to UK real estate (or companies who are sensitive to real estate) is problematic. We only need to look at Greece, where the pension system collapsed not due to a lack of funding, it was wiped out by the synchronous decline of the country's property, stock and bond market, in which the pension system was wholly invested.

In conclusion, ESG factors taken "de facto" risk increasing the LGPSs collective concentration and non-financial risks. However, with the right help ESG, but more importantly, Socially Responsible Investing can benefit the portfolio by including firms in the most important growth area of this generation: Renewable Energy and Energy Efficiency.

The asset owner who sees this new growth area also understands that it needs a new mind set. Politically exposed owners, such as LGPSs, cannot afford to adhere to the old adage of big is best when investing as the non-financial repercussions can cause significantly more harm than the financial ones.

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