OFFIT CAPITAL

THE ABC'S OF ESG INVESTING

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Summary Points

- **Investing with an Environmental, Social and Governance (ESG) orientation has become a widely discussed topic lately. What this means exactly and how to best execute an ESG plan remains mysterious for many.**
- **Early ESG efforts were almost exclusively negative screen vehicles, avoiding stocks and bonds of companies that engaged in industries or geographies contrary to an investor's values. Later, positive screens were created that try to identify virtuous behaviors by corporations in order to overweight investments in those companies. Both screens have their challenges.**
- ***More recently an entire industry of ESG indices, funds and ETFs has appeared. Competing firms score thousands of public companies globally on a wide range of ESG metrics. The challenge has been on agreeing on how to measure and weight these metrics. Consistent measurement has been elusive to date.***
- **"Impact Investing" is typically designed to direct private capital to specific industries and activities to achieve ESG. Some have claimed that they can earn superior returns while directing an ESG agenda. Others argue that any really effective ESG program will by definition sacrifice profits, but the improvement to society is worth the lower returns.**
- **Another approach, which we dub the Hippocratic Oath strategy, says first do nothing in a portfolio that is contrary to an investor's fundamental beliefs, and then invest to maximize returns. The investor is then free to use those profits anyway he or she chooses to try to achieve specific ESG goals. This has numerous advantages, not least being the donor should have more direct control over the ESG efforts versus being a shareholder or LP with limited influence over a company.**

Anyone who has been in the investment business for decades understands well that there are fashions that come and go on a regular basis. Sometimes the fashion, like passive indices, arises from a genuine improvement in the way we invest, and the fashion becomes mainstream. Many times, however, the fashions are simply created to attract an ever-optimistic public seeking the next great thing. Widely distributed products like portfolio insurance, UCITS hedge funds, and a whole host of others now largely forgotten, succeeded in making a lot more money for their creators than for the investors who bought them.

Environmental, Social and Governance (ESG) investing has been around in one form or another for more than 20 years. More recently, however, the product offerings that claim an ESG orientation have proliferated widely. There are more related indices, funds and ETFs than ever before, but there is considerable confusion among investors as to what is being promised versus delivered. This month's Commentary attempts to describe the history and current landscape to help determine whether ESG investing is a permanent improvement or just the most recent entry in a long list of fashions that come and go.

Negative and Positive Screens and Impact Investing

Some equity investors have for many years been concerned with some social and environmental issues to the point where they want to avoid association with companies they believe fail to share their views. When South Africa was ruled by an apartheid government, some investors sought out "South Africa Free" funds that excluded owning public companies with economic ties to that nation. This is a classic example of a negative screen in a portfolio. Other widely used negative screens have included oil companies, tobacco and arms manufacturers. The list is potentially boundless depending only on the investor's priorities.

While negative screens may ease the minds of certain investors, it is not clear that they make any progress in changing the behavior of companies. If, for example, the investors who are most sensitive to environmental issues all sell their oil stocks, those shares will be owned by less concerned people. The voice of the shareholders will be more uniform in ways the negative screeners would seriously challenge. Proxy voting is often dismissed as a minor activity of shareholding, but it is one of the most public means of getting critical issues addressed by boards and management.

The flip side of that coin is positive screens. Investors support corporate missions aligned with their world view through overweighs in their public equity portfolios. In private equity, investments can be even more directed by providing capital with a specific purpose. This is often referred to as impact investing and examples include funding micro-lending in developing countries, alternative energy generation projects, and developing clean water technologies.

Enter the Scorekeepers and Index Providers

Today, investors demand analytical support for everything they do. ESG investing started out primarily as a qualitative endeavor, but now that is not good enough. Sensing a growing and potentially large market for their services, traditional index providers like Dow Jones and MSCI have developed suites of ESG indexes along different themes. To help equity investors sort out companies along ESG lines, specialty data companies have evolved to score thousands of public companies globally. Three of the industry leaders are Bloomberg ESG Data Services, RobecoSAM, and Sustainalytics. There are many others.

Firms collecting and analyzing financial data like cash flow, debt obligations, and earnings have been around for decades. Analysts may disagree on what the data means, but it is generally produced from audited accounting reports over which there is wide acceptance of practice. ESG data is another story altogether. One data provider says they consider over 400 ESG variables, of which 170 are "meaningful." These metrics include governance factors like the number of women and public directors on a board. Environmental factors include water and energy management. Social factors like diversity hiring standards and compensation measures are also part of the mix.

In what has to be one of the most ambitious analytical projects ever contemplated, these firms attempt to rate each company on all of the relevant factors and then combine these results into a total ESG score. This is more complicated than comparing apples and oranges. It is more akin to trying to group apples, monkey wrenches and portable phones to create a standard measure of consumer satisfaction. Not all companies report on all of the metrics the raters would like to see. Omitted variables are ignored by some vendors while they are penalized by others. The weighting schemes behind the aggregate scores are complex. The results can be baffling to users.

Acknowledging that not every investor cares equally across all of the ESG factors, the data providers give considerable detail behind the aggregate figures. This may help some focus on those topics most important to them, but ultimately it is just a massive data dump where more numbers does not automatically lead to more knowledge or understanding.

The following table shows three major ESG composite scores reported on Bloomberg for a sample of global car companies. In all cases the closer the score to 100, the better the ESG status of the firm. The best scores by each provider are in green, the worst in red. A quick look at the chart shows only a modest amount of consistency across the data vendors. Tesla prides itself on leading the auto industry into a carbon free future. That apparently doesn't impress either RobecoSAM or Bloomberg in calculating its ESG profile. Volkswagen with its well-publicized diesel emissions scandal was placed on the bottom of its list by Sustainalytics, but received the second highest mark from Bloomberg. GM and Honda get high marks from one provider and middling to below average from another.

ESG Ratings

	RobecoSAM	Sustainalytics	Bloomberg
BMW	88	93	67
Ford	38	54	47
GM	96	64	59
Honda	92	75	47
Peugeot	100	100	60
Tesla	4	50	19
Volkswagen	54	43	63

Source: Bloomberg

At last count there were more than ten providers of ETF products based on a wide variety of indexes that did not exist just a few years ago. Some of these try to stay sector neutral with respect to indexes like the S&P 500 and then populate the names with companies at the top of someone's ESG charts. Others have devised other portfolio weighting schemes combining better ESG companies, but depending on whose scores you use one ESG portfolio may hold Honda but not Volkswagen while another would own the reverse.

This is where the concern about fads grows. Fund and ETF providers often sell their products using pro forma performance data looking back through time when little ESG investing was being done. Others use short actual time series that show outperformance versus a major index like the S&P and claim they have proved the approach performs well while also doing good. We have been here before. In the late 1990s, funds that excluded oil and tobacco stocks claimed their ESG portfolios were fundamentally and permanently superior. Those portfolios often replaced the missing allocations with tech stocks. The outperformance wasn't so much ESG-related as it was a basic sector bias. When the tech bubble burst in 2000, outperformance quickly turned to underperformance. Another group of sales people then began touting the investment advantages of owing "sin stocks." There is always something being peddled.

The other obvious challenge in ESG investing today is the proliferation of funds and managers that are genuinely mediocre or worse, wrapping themselves in an ESG cloak to rationalize their underperformance. They could never sell a traditional product given their skills and track record, but when they lag in an ESG mandate they can always point to their completely unquantifiable positive social impact. Given the wide range of options available in the marketplace, ESG investors should be just as discriminating in their choice of products as they ever are with traditional funds.

An Alternative Approach

Rather than chase some organization's stylized version of an optimized ESG portfolio that may or may not align with your world view, perhaps it is better to step back and focus on what is most important to you. There is no simple solution available in this approach, but it may best align with your goals and beliefs.

Hippocrates was a Greek physician who lived from 460 to 370 B.C. He was also a noted philosopher and writer who is most famous for his Hippocratic Oath, which lays out a code of ethical conduct for physicians. It has been modernized over the centuries, but its core principles are still in place today. One of the pillars is the admonition that a physician should first do no harm to the patient. Perhaps this principle can be used to guide our investments.

Nobody should ever make an investment that is contrary to their moral fabric. Full stop.

This may seem too obvious to state, but you might be surprised how often investment ideas are sold by people who appeal to modern financial theory and any other handy device to counter reservations the prospect may have based on their own values. Some people may embrace investments in the emerging cannabis industry. Others may be repulsed. Nobody in the latter camp should be asked to compromise their beliefs just because the investment might be a great diversifier.

Once nothing you own is in conflict with your values, the next step should be to shape the best portfolio possible to maximize returns subject to your target level of risk. If you are successful, you can take your enhanced wealth and direct it to projects and causes that further your personal goals. By separating the investment and social action pieces, the portfolio does not get clouded by competing, and perhaps conflicting, goals, and there is more control over the use of your resources than could ever be achieved as a shareholder in a public company.

This approach does not preclude specific impact investments on the private side as long as an investor understands that the price for achieving influence might be below market returns. People do many things like backing theatrical plays with the understanding that money is likely to be lost, and they do it willingly because they want to support the arts. This is one narrow form of impact investing where the broad benefits to the artists and the audience never get captured by the investor. There are many other similar activities across the ESG spectrum available to investors wanting to make a difference. The challenge is to identify the best practitioners to get the most ESG impact for each dollar spent.
