Sadly, the 'E' in ESG is Mostly Nonsense

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> *"How far that little candle throws his beams! So shines a good deed in a weary world."*
>
> William Shakespeare, The Merchant of Venice

With COP26 starting in Glasgow this weekend I'd like to reiterate why at Eriswell we believe that 'ESG' investing is mostly nonsense: In terms of the 'E' that is. A Festival of Slogans, puffed-up with impenetrable jargon, fuzzy notions of 'profit and purpose', and 'stakeholder reporting'. Worse, ESG is too often designed to curry favour with governments, the public, and regulators to derail the new regulations necessary to tackle the environmental and social challenges we face today.

Big finance has meanwhile been swift to optimise the dubious and lucrative streams of ESG investment fees.

None of this is to say that Eriswell doesn't care about ESG issues, we do. In terms of the 'S', we fund programmes to support some of the UK's most deprived children and, for the 'G', we are pioneering #DemandFullTransparency to tackle excessive fees in the retail savings industry.

Turning to the 'E', we'd like to use Tobacco as a real-life investment example to demonstrate why ESG investing is a hopeless tool for tackling climate change.

We don't claim to have the answers and we'd love to hear your insights: either below or you can email them to info@eriswell.com

ESG Investing: The Theory

The premise underpinning ESG investing is that one can reliably separate 'good' and 'bad' companies and then force change by penalising the 'bad' companies by increasing the cost of equity capital we invest in their businesses.

The idea is to then compel commercial banks to follow suit by altering their regulatory capital requirements to embrace climate change and sustainability. The idea being to increase the regulatory capital banks must set aside against loans to 'bad' companies, thereby increasing the cost of loans to them.

This may all seem fair enough, so let's follow the flow to see what happens down the line:

In the short-term

Increasing the cost-of-capital of 'bad' companies is another way of saying that investors will pay a lower earnings' multiple (P/E ratio) for their shares, which will consequently fall. Conversely, investors will pay a higher earnings' multiple for shares in good companies which will consequently rise.

Investors who spot what's going on can make a speculative profit by buying the stocks of 'good' companies and selling those of 'bad companies.

So, speculative investors are happy, but what about the environment and social change? Well, let's see:

In the-longer term

Imagine at this point you roll up and ask Eriswell to manage your pension funds. We can now offer you a choice between 'good' companies offering low returns on capital (because their stocks have gone up so much), and 'bad' companies offering higher returns because their stocks have fallen.

We may even advise you that segments of the renewable energy market have become bubbly and probably best avoided for those trying to grow their funds. Moreover, we may tell you that, if you want to maximise your investment returns, you may need to consider investments in Mining, Oil, Defence, and dare we say it Tobacco, all of which have been left far behind.

Now let's say you stick to your principles and refuse to be tempted by the high returns offered by 'bad' companies.

Along will come a private equity company to scoop-up these 'bad' companies and bag the tidy discount created by ESG selling. You will then no doubt read about how its clever lawyers gamed the tax system and turbocharged the already high returns. Remember, there is currently over $6 trillion sitting in private equity globally right now, over twice the size of the entire UK economy. Of this over $1 trillion is sitting in hard cash.

Does this seem fair to you?

At which point your jaw drops in amazement when UK Chancellor of the Exchequer, Rishi Sunak, cheerfully announces that he may allow UK pensions to invest in private equity and to pay the high fees they charge for what you could have done by yourself in the first place for next to nothing.

Bonkers!

Winding back a bit, how do we separate 'good' and 'bad' companies in the first place?

Management Consultants and ESG Scores

Enter stage the management consultants, who criss-cross the world (First Class of course) as they rush to develop new 'ESG Scores'. That is to boil a company's positive and negative environmental and social influences into a neat two-digit ESG Score which fund managers can then act on to maximise the social good.

The trouble is there is no way on earth to do this and it is naïve and deceitful to claim otherwise. Whether we talk about mining, oil, manufacturing, or service companies, all are embedded within complex chains spanning product supply, usage, customer behaviour, emissions, subsequent recycling, and so on.

Few of these companies have a clue about these complex chains: for example, a steel company cannot know whether its steel will ultimately end up in a new MRI scanner, or a howitzer gun for some tyrannical regime. They cannot therefore know if they are helping to maximise the social good or not.

No ESG scoring system can resolve these global complexities.

Let's now turn to Big Tobacco: that's got to be bad, right?

British American Tobacco: A 'bad' company best avoided – Or is it?

From the 1960s, the tobacco industry was caught red handed trying to alter the science to cover-up the indisputable fact that smoking kills. A crime so bad that in 1998 US Senator John McCain almost got a bill through U.S. Congress that would have finished them off.

Congress baulked, and Big Tobacco including the UK's British American Tobacco (BATS) escaped to become the darlings of income investors throughout 2000s and early 2010s. Many, including us, viewed this as an abject failure of government, but with the legal and new regulatory frameworks set, it was perfectly legal for these businesses to continue their businesses.

Should we investors now try to finish what democratically elected lawmakers failed to do? That's not an easy question; can you imagine a world where financial firms control our societies' legal and ethical frameworks?

But for the sake of argument, imagine that we investors collectively go ahead and raise the cost of BAT's equity and debt capital so high that it struggles to survive and that the UK government somehow bans private equity from buying it.

The world is currently awash with capital and before long, attracted by its by now high returns on capital, BATS would probably end-up being bought by the sovereign wealth fund of a distant foreign regime.

Which would be a serious own goal for ESG.

With Western investors side lined, there wouldn't be the shareholder pressure that, for example, recently prompted US tobacco giant Philip Morris to buy Vectura, a UK developer of medical inhalers, as it tries to turn itself into a "Healthcare and Wellness Company". Okay, we laughed at that too, but what if local shareholder pressure prompts tobacco companies to pioneer new and useful research on inhalable medicines, and to honestly take health more seriously?

While this path looks more promising BATS, like all companies, is ultimately bound by strict legal frameworks and conventions, some of which date back to the early Industrial Revolution.

1850 Corporate Structures Don't Fit 2021 Problems

Since the early-1800s, our societies and legal frameworks increasingly revolved around business activity at the heart of which lay the notion that companies primarily existed to maximise shareholder wealth. This idea remains dominant today, whether it be in setting CEO compensation, management targets, employee incentives, and suchlike. It is by now deeply engrained in our social and legal frameworks that private firms should do one thing above all else: extract profits and deliver them to their shareholders.

The trouble is, the Industrial Revolution which these laws were designed to protect is now ruining our planet.

Our legal structures, social systems, and corporations must all be redesigned to resolve these problems and there is no getting away from that.

Conclusion

I despair every year when the great and the good fly their private jets into Davos to discuss adapting our financial systems to guard against risks related to climate change. They appear to mistakenly believe that tinkering around the edge of global finance is going to miraculously make companies fit for a radically different purpose than that for which they were designed.

The fact is, until we change incentives long the entire *'investment-production-consumption'* chain, we cannot expect to deliver anything close to the impact needed to combat climate change and other social problems. Carbon markets are part of the solution although there are still questions about companies buying offsets against CO2 emissions from groups that notionally capture carbon.

If ESG investing wants to achieve anything positive – in terms of the 'E' that is – it must focus on forcing governments to broker a new 'New Investment Deal'.

New laws and regulatory frameworks can then define new playing fields and investors can set about backing those businesses best able to navigate them.

Until such time, small investors can be forgiven for joining the 'smart money' in protecting their own portfolios from ESG-induced distortions to asset prices.

While openly acknowledging that this is not the same thing as preventing devastating climate change from happening in the first place.

It cannot be acceptable that financial firms, management consultants, etc. make tidy profits behind the ESG Smokescreen while everyone else pays the price: monetarily and ultimately environmentally.

For any enquiries or comments you may have, please contact us at info@eriswell.com. We look forward to hearing from you.

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