Eriswell Market Insights

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Are ESG Investors Smarter than a Fiddler Crab?

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Can ESG investors help heal the world's social and climate ills? Can they even identify companies moving towards a distant and desirable equilibrium? And do you trust them?

Our New Year's Edition last year was entitled "Are You Smarter than a Honeybee?" So, this year's question is: Are ESG Investors Smarter than a Fiddler Crab? As ever, you decide:

Flaky ESG metrics are blunting the positive impact achieved by the self-avowed $38 trillion currently following ESG strategies. This is forecast to increase to $53 trillion in 2025, over a third of the projected $140 trillion of assets under management by then.

The worst possible outcome would be if well-intentioned ESG investors earn sub-par returns while achieving little tangible good, thereby leaving fund managers, bankers, and ESG rating firms as the big winners.

Were that to happen, people seeking a good return on their savings will swiftly turn to scorned but lawful businesses such as Defence, Drinks, Casinos, Cannabis, and other companies where the expected return on equity increases as ESG investors sell up. In fact, 'BAD ETF', (ticker BAD) has just been launched to target exactly these stocks!

To see how tricky this gets, do you think Defence is a legitimate investment? What about nuclear weapons' guidance systems? In 2006, UK Defence giant, BAE Systems was blacklisted by Norges (Norwegian sovereign wealth fund and largest stock investor worldwide) *"because they develop and/or produce central components for nuclear weapons".* Consistent with Norges, ratings firm 'ISS ESG' assigns BAE a 10, its worst possible rating. MSCI by comparison assigns BAE an almost perfect AA ESG rating.

UK pharmaceutical giant Astra Zeneca is also one of the BAD ETF's top sin stocks, despite it being the largest manufacturer of Covid-10 vaccines by far.

See what a mess this is?

If we are to achieve anything worthwhile, fundamental changes are required beneath the corporate waterlines.

Because until we change incentives along 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. New laws and regulatory frameworks must define new playing fields and investors can then set about backing the businesses best able to navigate them.

Top of the list for review is the increasingly obsolete corporate 'profit maximisation' model by now deeply enshrined in our laws and social systems. The overarching objective must be to foster the development of a corporate ecosystem in which 'better' companies can evolve that embrace a wider constituency of stakeholders than shareholders alone.

Moreover, the cornerstone of modern finance – the operation of free markets – is unlikely to provide a solution on its own. This is because companies have an inherent incentive to game the system to maximise their chances of success. It works just the same in nature.

Take the colourful peacock: By opening its flamboyant tail, the peacock is sending an 'honest' signal to potential mates that it backs itself to outrun lurking predators and is therefore a good mate. A less prime peacock may decide against showing its colours publicly if it judges itself too weak to run away.

Can you see an element of game theory lurking in the background?

A crafty little character known as a Fiddler Crab certainly has! These crabs are known for having one large claw for fighting and a smaller one for feeding, etc. Should the male fiddler crab lose its big claw in battle, a replacement will swiftly regrow; just as big, but lighter and weaker than the original. The replacement claw sends a dishonest signal that this male is battle fit again and it attracts breeding females just fine. The trouble is, should a passing male accept a challenge, the dishonest crab must calculate when to back down against a contestant sporting its original more heavily armoured claw.

Where profit is involved, companies have a track record in taking such dishonest signalling to a level far beyond the little Fiddler Crab!

At which point another problem enters the arena and matters take a turn very much for the worse: Trust in the financial services industry is at an all-time low. (*'Are You Smarter than a Honeybee?',* Dec 2020)

In which light, we should not be surprised that free markets don't produce businesses which best support the future of the human species; given that they are woven from a tapestry of companies gaming imperfect regulatory systems, under the tutelage of sometimes untrustworthy professional investors.

The most obvious problem is that a profit-seeking company is induced to game the system in ways which benefit it and its shareholders while inflicting negative externalities on society as a whole.

And this leads to a secondary, more subtle problem: A business cannot evolve unless it is successful throughout its entire journey, including bleak times. Indeed, the process of evolution in nature displays many localised comparative-advantage peaks of transiently successful species, now long disappeared in the mists of time. Equally, there is a risk that companies and consumers moving towards a distant and desirable future equilibrium, may end up running out of steam and going bust along the way because of similar evolutionary short-sightedness.

The ESG investor's job is to figure and get ahead of this formidably complex game.

So, can we cool off labelling businesses as 'bad' and 'good' and then naively assuming them to share the characteristics of every so-labelled item. For at this stage, we cannot be at all sure who are the good guys. To illustrate this point, think of UK industrialist Henry Bessemer who, back in 1856, devised a steel making process that reduced the price of steel from around £30 to about £6 per ton. This helped power a new stage of the industrial revolution by supporting high-pressure steam engines, better railways, shipbuilding, new infrastructure, and a massive coal industry. The ensuing employment gains in new higher-productivity ancillary businesses produced a powerful localised fitness peak within these new industries.

Sadly, in the longer-term, these new industries would sow the seeds of the 'ecocidal' climate externalities we see today.

On a more positive note, if honeybees, peacocks, and fiddler crabs can suss subtle games, perhaps we can too?

Here's to a Happy and Super-Successful 2022!

Team Eriswell

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