When ESG execution misses the point

Investors need to ensure their selection processes help narrow the focus to what should matter most.

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Environmental, social and governance (ESG) has become the buzz phrase of the moment. But like many before, it has often been met with confusion, misapplication or, worse, misrepresentation.

This was seen last month in the US, when after US politician Alexandria Ocasio-Cortez announced her Green New Deal initiative, proposing a stimulus package that aims to address climate change and economic inequality, a junior staffer unwisely released to reporters a draft of a Green New Deal FAQ containing a passing joke about bovine flatulence and airplanes.

Such trivialisation has hindered some in utilising this mainstream investment tool to help narrow the focus to what should matter most.

This lit a firestorm across not only media outlets – with fear mongering that (beef) hamburgers could be banned by Ocasio-Cortez – but also activist investment communities which led calls for ESG-responsible asset and investment managers to rein in mass livestock flatulence contributions to global methane emissions.

In a stranger development still, New Zealand was pulled into the middle of this international responsible investing fracas when this month its parliament introduced zero carbon legislation aiming to reduce all greenhouse gas emissions to net zero by 2050 but, importantly, excluding all livestock-emitted “biogenic methane”, which in effect excluded cows as an ‘E’ contributor to any ESG-focused portfolio investment.

This provoked several activist investment communities to call for New Zealand to be boycotted from future MSCI World passive index investments, which if realised, would have catastrophic consequences for the New Zealand's Exchange (NZX) and economy.

But the ultimate irony of this mass confusion has been that, according to the Food and Agriculture Organisation of the United Nations, although 14.5 per cent of global greenhouse gas emissions is thought to be emitted by livestock with cows being the main culprit, it is in fact cow burps that produce 90 to 95 per cent of the methane released by cows while 5 to 10 per cent is released in the form of manure and flatulence.

Such trivialisation has not helped investors discern what are responsible investments and has hindered some in utilising this mainstream investment tool to help narrow the focus to what should matter most.

Global growth

Sustainable investment assets globally have grown by over 25 per cent from 2014 to 2016, according to the Global Sustainable Investment Alliance, with the largest pockets of recent growth coming from the US, Canada, Japan, Australia and New Zealand.

While Europe remains the leader in ESG assets, with over 52 per cent of all global ESG managed assets, countries such as the US now represent 38 per cent.

In the US alone, actively managed ESG assets have grown at a 29 per cent compound annual growth rate (CAGR) since 2010 across specialised investment funds (SIFs) and this represents a nearly fourfold compounding growth rate compared to actively managed US mutual funds, which have enjoyed a 7 per cent CAGR increase.

But here too, misapplication and misrepresentation distort value creation and raise risks for shareholders and challenges for portfolio managers, analysts and private advisors attempting to discern which ESG investing opportunities offer a differentiated and additive complement and which are chicanery.

Despite the rise in the use of big data and more than 100 organisations dedicated to analysing and rating company ESG performance, according to the Global Initiative for Sustainability Ratings, Australian-domiciled domestic and global investors – especially when it comes to listed companies – continue to struggle to separate the wheat from chaff.

Innes Willox, CEO of business advocacy outfit Ai Group, says: “The ESG space is rocketing in importance for our major, globally-focused companies, in part to meet regulatory, employee and social demands as well as those of major investors, including superannuation funds, who are in turn seeking to meet the needs of their own investors. This is a trend which is not going to disappear and nor should it.”

ESG scoring

Fortunately, according to Goldman Sachs, quantifiable ESG metrics are growing rapidly and are being brought to mainstream investment communities in Australia.

Following Goldman’s ESG scoring methodology, for example, BHP has performed well historically but most recently it fell relative to its mining and materials peers.

This scoring was mainly due to the Samarco (Brazil) dam collapse, which resulted in 19 fatalities in 2015, raising the company’s fatality rate to the 67th percentile versus the prior year’s zero fatalities.

Because fatalities can be a relatively volatile metric from year to year compared to more stable metrics, such as energy use and diversity, this single event resulted in a significant negative swing from the previous year’s overall positive score.

But according to this scoring methodology, BHP also scored poorly on waste recycling, hazardous waste intensity and employee turnover, but scored favourably on water withdrawal and renewable energy usage.

Being mindful to ensure that hype does not impede steady investing, investors need to ensure their ESG processes add clarity and assist in identifying investments into listed companies that, for instance, continue to carry elevated operational risks linked to lagging ESG performance (as the recent banking royal commission made apparent).

It is becoming evident that ESG metrics can provide a differentiated complement to mainstream investor toolkits that allow discerning Australian investors the opportunity to tap into one of the fasting growing-asset pools.

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