ESG: Beware of simple solutions to complex problems

David Kneale, Head of UK Equities and Paul Waters, Head of Institutional, UK & Netherlands at Mirabaud Asset Management

The majority of asset managers continue to extend and enhance the use of Environmental, Social and Governance (ESG) factors in their processes in response to increasing demands from institutional investors, governments and industry bodies.

Whereas some of the early adopters considered ESG under the headings of responsible investment and corporate social responsibility, it is finally becoming recognised as a means of increasing long-term returns to shareholders by reducing operational, reputational, regulatory and legal risk and ensuring appropriate non-executive oversight. It also promotes good relations with governments, communities and societies within which businesses operate. Furthermore, we have all seen examples where delivering longer term benefits to the environment has created a happier labour force, customers and investors.

Examples of good ESG practice are both inspiring and compelling in illustrating the gravity of the long-term benefits to society and the environment.

Case Study 1: Papua New Guinea

Jared Diamond, Professor of Geography at UCLA, provides first hand evidence of the benefits of sustainable practice in resource extraction. One of the best locations to see rare wildlife on the island of New Guinea is at Chevron / Oil Search's Kutubu oil project. The company has worked hard to minimise its impact on the landscape and wildlife, engaging constructively with local populations to ensure that it is seen as a positive for the region (it contributes almost 20% of government revenues). Chevron does this for several hard economic reasons; it is far more expensive to clean up spills than prevent them and it is extremely expensive to lose local support for your projects as this risks delays, sabotage, loss of permits or raised taxes. Finally, the Chevron workforce is far more sensitive to their environmental impact than ever before – this means damage to the environment impacts morale and increases staff turnover.

Rio Tinto's experience on the same island demonstrates the opposite path: disputes with the local population over environmental destruction, poor wages and the unfair distribution of profits at the Panguna copper mine led to violence on the site. This ultimately escalated into a separatist rebellion, which led to thousands of lives lost and a formerly hugely profitable mine being closed for 25 years. It is very clear which approach is best for shareholders.

ESG lays an extensive collection of overlapping and interrelated considerations on the doorsteps of asset managers, many of whom, to date, have been focused on delivering short-term financial success. In many instances, the managers in question lack the expertise and the tools to address these challenges. Indeed, they are often attempting to do so from a starting point in which their business structures, processes and incentives are poorly aligned.

Many asset managers have therefore turned to third-party ESG consultants and analysts to help address this gap. However, very few ESG consultants have a deep grounding in financial and strategic analysis. It appears that ESG consultants are attempting to cover too wide a waterfront with too little resource. For example, we regularly see standard scoring systems penalising companies for failing to implement a policy or disclose a statistic that is entirely irrelevant to their business. Similarly, we see conventional ESG analysis miss both risks and mitigating actions that become apparent from the deep-dive due diligence conducted by many asset managers.

Case Study 2: Plastics

Plastic packaging is under considerable scrutiny owing to the catastrophic effects of waste plastic on marine ecosystems. However, plastic is something of a wonder-material; its properties offer a huge array of potential uses and benefits, though these come with problems if not

treated with sufficient care. The use of plastic is not the problem; it is the poor management of waste plastic that is the problem. Fully assessing the environmental and social impact of plastic is extraordinarily complex and often counter-intuitive.

We have all stared in horror at the environmental madness of the polythene wrapped cucumber on the supermarket shelf. What are they thinking? The average cucumber has a carbon footprint of, very approximately, 8g CO_2e (allowing for the costs of transportation, fertilisers, irrigation, etc)[1]. The carbon footprint rises by ~0.4g CO_2e if we wrap it in polythene (polythene has a dramatically higher carbon intensity, we just don't need very much of it). So our plastic wrapped cucumber has a 5% greater carbon footprint. A plastic wrapped cucumber has a shelf life of 14 days, compared to 3 days for an unwrapped cucumber. This means that we almost certainly reduce wastage and the total amount of cucumbers purchased into the supply chain. If nearly 5x longer shelf life only lowers cucumber demand by 10% (a very conservative assumption) then the plastic wrapped cucumber is both financially and environmentally better. This calculus becomes exponentially more complex as we adjust for the carbon emissions of composting waste cucumbers and recycling the plastic, or using biopolymers, or energy from waste facilities.

A simple conclusion that plastics are environmentally damaging is dangerously misleading. There is a glorious irony that plastic packaging producers are penalised for the environmental impact of their products, yet their customers (the Fast-moving Consumer Goods, or FMCG companies) are praised for the steps they are taking to make their products sustainable. Advanced packaging producers such as RPC could make almost all of their products from biopolymers, recycled polymer, photo-degradable polymer and compostable polymers – never mind making them conventionally recyclable. Every one of which would be more profitable for RPC. The only reason that they do not do this is the specification handed down to them by their customers (whose soap bottle would not be quite so perfectly bright white without virgin materials). Conventional ESG analysis is 100% backwards. The problem is the FMCG industry.

The level and rigour of research required to properly understand a company's environment, social and governance footprint is substantial. We believe this approach goes beyond just being satisfied with third-party research. Any decision around investing based on ESG factors is complex and must be combined with business strategy and financial success. Any objective to achieve long-term change to Environmental, Social and Governance practices must adhere to the Darwinian laws of business competition. ESG best practice must be married to financial success, which will require any ESG efforts undertaken by companies to be appropriate, proportionate and effective. Burdening businesses with marginally useful bureaucracy will not help. This demands that shareholders be active and engaged. Investors must have a full understanding of the business implications of what companies are being asked to achieve. In many instances there will be a short-term cost but, as a true investment decision, this will bring long-term gain.

Case Study 3: Berkeley Group

As one of London's largest residential developers, Berkeley has many areas of significant social and environmental risk within its business. Urban regeneration will always require close co-operation with local residents and governments. Damaging these relationships will materially undermine the long-term prospects for the group

A low cost or passive approach has many advantages, but today almost entirely lacks sufficient expertise to be able to [...] demand significant changes in business practice

and they must be managed carefully. Berkeley does not always score particularly well in standard ESG screening, but to our mind it provides one of the very best examples of long-term sustainability.

Even though Berkeley was not involved in the construction of Grenfell Tower, the terrible fire triggered significant action at the company. Berkeley reviewed every building they had ever built to check that no flammable cladding materials had been used. They then visited every location to re-confirm that the fire safety measures, such as highly visible and accessible fire hydrants, remained fully functional. Finally, the company accelerated the construction of 68 apartments in their nearby Kensington Row development, which they sold to the government at cost to re-house displaced Grenfell residents. The management team are crystal clear: the route to long-term success for their business is engaging constructively with all stakeholders and building homes in which people want to live.

Ultimately, as with so much in investing, this boils down to extensive research and considered judgement to minimise risks and maximise long-term returns. The judicious allocation of capital by forward-thinking investors can have a dramatically beneficial impact, not only on their own returns, but on the welfare of all stakeholders in the businesses that they own. The due diligence intensive approach of high conviction, active managers is best positioned to integrate these additional considerations (after all, many have been doing so for decades without labelling it “ESG”). A low cost or passive approach has many advantages, but today almost entirely lacks sufficient expertise to be able to credibly analyse all of these factors and demand significant changes in business practice bringing material implications for short and long term investor returns. ●

1. Chalmers University of Technology, Sweden, 2012 (assuming transportation from Spain to the UK is roughly equivalent to transportation to Austria)