

ESG: Some Assembly Required



Adam Beaser October 4, 2022

Introduction

Have you ever bought something that looked easy to assemble, but turned out to be harder than you thought? At Syntax, that's how we feel about ESG investing. We dove into the ESG space in 2015 and found, almost 8 years later, that we are still adapting to new developments. What seems a simple enough concept in principle – investing in companies with good environmental, social, and governance practices – has become increasingly complex.

The July 23rd issue of The Economist (see Appendix) provided an in-depth assessment of the challenges and problems associated with the present state of ESG investing. The series of articles analyzed ESG from the perspectives of different stakeholders, including investment managers, ESG rating agencies, individual companies, regulatory entities, and investors. It highlighted a host of issues such as “greenwashing”, a lack of uniformity in ESG ratings across rating agencies, and the complexity of proposed regulations. In this paper, we provide our thoughts on why ESG is hard and how investors can navigate this complex space.

Why ESG is Hard

People like to assign letter grades or scores to make things comparable. Restaurants are rated on a scale of 1 to 5 on apps, students are given grades to assess how well they do in a class, and we are all familiar with corporations asking for feedback scores on their level of client service. Similarly, rating agencies provide ESG scores on companies, and organizations like Morningstar provide ESG ratings on manager portfolios. These scores make easy reference points which we all like, but with simplicity comes challenges.

Consider Tesla: as the most recognized electric vehicle company in the world, Tesla is leading the decarbonized vehicle movement. At the same time, the batteries used to power these vehicles rely on minerals that are produced in mines that damage the environment and emit carbon in the extraction processes. Tesla has also been criticized for its corporate governance, which gives it a low “G” score, and its history of labor violations drives down its “S” score. So, when evaluating Tesla, how much weight do you assign to their role in reducing fossil fuel usage? How much should the reduction in carbon tied to their vehicles be offset by carbon produced by their supply chain? And how should their low governance score impact their overall ESG score? Like everything else in investing, ESG scoring must contend with tradeoffs.

The Economist noted that when rating agencies provide credit ratings on companies, there is a 99% correlation of results across firms. Much of this is driven by the analysis of standardized financial data. But the correlation of ESG scores produced by rating agencies is roughly 50%. The differences were tied to:

- The scope of activities Included or not Included.
- Different measurement metrics; and
- Weighting Differences

ESG ratings might purport to be objective and quantitative, but they can be highly subjective. Investors should be sure to understand the process by which ESG scores are calculated. If an off-the-shelf ESG scoring solution does not fit with either your ESG or your financial goals, consider a customized scoring approach. Or depending on your goals, you might want to avoid ESG scoring altogether and take a different approach to ESG.

What Do You Want as an Investor?

Given these challenges, in ESG investing it is important to first define your investment goals. Before diving into the space, investors might want to consider some of the following questions:

- Do you view ESG as a sensible due diligence tool to help assess non-financial risk?
- Do you view ESG as a tool to align a portfolio with your personal values or the values of an organization you represent?
- Are there specific ESG characteristics or themes that you believe are well-

positioned to generate attractive long-term returns?

The answers to these questions will help inform the best approach for you. You also need to address your return expectations. The Economist report highlighted that ESG has often been viewed and marketed as a "win-win" opportunity for investors, where you can do good and earn excess returns. They cited several studies that poked holes into this idea, contradicting the results of other studies. Based on Syntax's analysis, we believe some of the observed outperformance of ESG strategies stems from a natural tilt toward technology companies, which score more highly on many ESG metrics since these companies are less resource intensive, and 2) have outperformed the market for much of the sample period considered in the analysis. That is, the outperformance seen in some ESG strategies may have little to do with ESG itself. That being said, there is evidence that sector-controlled ESG strategies, which avoid technology concentrations, can outperform similarly sector-controlled benchmarks. All in all, whether or not ESG can outperform is not cut and dried.

ESG has been a boon to the investment management industry, helping offset two decades of declining fees tied to the ongoing growth in passive investing. Up to \$35 trillion in assets are now managed under the umbrella of ESG integration strategies as investment managers have successfully marketed their ESG skills to meet demand from investors. A fee analysis from Morningstar showed a fee premium for sustainable funds where the average ESG fund had a fee of 61 basis points vs. 40 basis points for traditional funds. This raises the question of whether investors are getting their money's worth from these higher fees.

ESG strategies also come in a continuum of product offerings for investors. On one end are exclusionary ESG strategies that seek to avoid certain industries, such as tobacco or fossil fuels. On the other end are impact focused approaches that target companies or industries that produce social or environmental benefits. Within this broad range of options, ESG can play a supporting role alongside traditional qualitative analysis performed by the investment manager, or it can be a primary driver in the security selection process.

Finally, there are additional dimensions investors need to evaluate as well, such as whether to pursue an active or passive approach, invest via mutual funds, ETFs or some other type of commingled vehicle, or to evaluate custom solutions such as a direct index

or separate account that offer more customized input into the ESG criteria. There are numerous pieces to solving the ESG puzzle, articulating your goals and objectives will help you make better choices.

Where ESG Goes from Here

It is unlikely ESG is going to get any less complicated in the near term as the scope of regulation and the availability of data collected to improve measurement will continue to expand.

On the regulatory side, the International Sustainability Standard Board (ISSB) is aiming to improve the consistency in non-financial disclosures, and the EU is pushing its Corporate-Sustainability reporting directive to become law in 27 member countries by year end. This will require 49,000 companies to submit information on sustainability. In the US, the SEC released a 490-page proposal earlier this year that would require companies to disclose current and future climate related risks and their potential impact on financial statements.

The need for better data to support more accurate measurement and decision making is real. The Economist referenced data from MSCI, which noted only 40% of public companies report Scope One and Two emissions. This implies decisions are now being made with constrained amounts of data.

The Economist's recommendations for the ESG space included:

- Investors should unbundle the E,S and G and place their focus on E, and specifically on emissions.
- To make ESG more effective, it needs to be streamlined and required disclosures should be tied to materiality for each industry.
- More focused metrics are needed to promote broader adoption globally, including private companies, governments, and emerging market companies.
- Asset managers should customize their offerings and sustainability funds should be marketed as impact investments, knowing there are other objectives than return.

Looking forward, based on our discussions with clients and prospects, we see ESG

becoming more nuanced and customizable. In particular, we see a growing interest in the ability to group companies that share common themes like Clean Energy or specific UN Sustainable Development Goals (SDG) such as Good Health & Well Being.

While we understand why The Economist suggests focusing on emissions given the impact of climate change on the planet, we do not believe other environmental metrics such as water management or recycling should be ignored. Individuals and organizations (such as endowments and foundations) should have the ability to align their investments with their goals or missions if they desire.

Final Thoughts

The goal of this paper is to provide the reader with some insights on the current state of ESG investing, and to identify questions you need to ask if you are invested in, or considering, ESG related investments. Our hope is to provide investors additional tools needed to make an informed decision and understand why we titled this paper *ESG: Some Assembly Required*. Choosing the right ESG related investment or building an ESG program requires some effort on the front end to realize your long- term objectives.

In the coming months, we will continue to share our thoughts on ESG, and we will touch on our approach at Syntax, which is centered around transparency, assessing materiality, and developing custom solutions.

Appendix

The Economist articles referenced from July 23rd, 2022, issue:

- ESG: Three letters that won't save the planet
- In need of a clean-up
- Asset managers: The savior complex
- Investors: The warm glow
- Companies: Internalizing the externalities
- Rating agencies: The signal and the noise
- The regulators: Missionary creep
- The future of ESG: Measure less, but better