Equity investing: IS IT AS EASY AS ESG?

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INVESTING ON the basis of a company's environmental, social and governance (ESG) practices is a growing trend in financial markets. In dealing with the uncertainty of financial markets, ESG as a stock selection rule of thumb has a certain appeal. Experience tells us that the investment challenge is never that simple.

In this short article we will consider an investment thesis for incorporating the broader concept of sustainability into equity portfolios. We will highlight some of the risks that various approaches may present and provide ideas for building better investment outcomes.

AN INVESTMENT THESIS FOR 'SUSTAINABILITY'

Redpoint believes that economic, environmental, social and governance (EESG) practices of companies can provide valuable investment insight. This view is founded on our investment thesis that EESG as a measure of 'sustainability' provides an alternate perspective on the quality of company management. Sustainability refers to 'good corporate practices' regarding companies' interactions with the broader economy, the environment, and society; as well as their approach to corporate governance.

Today's 'sustainability' focus has evolved from investor interest in socially responsible investing (SRI). SRI gained prominence in the 1980s in response to the anti-apartheid movement

advocating divestment in firms engaging in business in South Africa. A long-standing SRI practice is to avoid 'sin stocks' such as firms that sell alcohol and tobacco products. Avoiding firms engaged in the production of arms and war material is another ongoing SRI concern. SRI has more recently focused on avoiding firms contributing to climate change.

This has evolved to a focus on firms engaged in non-exploitative, sustainable economic activity. More recently, sustainability criteria have become associated with a wide range of management best practices common among well-run, high-quality firms, positioned to succeed over the long term.

FROM 'AGENT' TO 'STAKEHOLDER' THEORIES OF THE FIRM

In academia, the evolution of sustainability parallels the evolution of 'theories of the firm'. Historically, the 'agency theory of the firm' was dominant in economics.[1] Managers were considered agents of the shareholders, hired to manage the firm. To maximise firm value, managers focused on minimising management (or agency) costs. From this perspective, many practices aimed at improving corporate sustainability were viewed as non-essential costs that reduced shareholder value.

Over the last 20 years, the dominance of the 'agency theory of the firm' has declined.[2] An extensive literature now documents the importance of good corporate governance practices to maximise firm value.[3] This management literature also documents a growing list of 'best practices' important to maximising profitability and firm value. This evidence has led to the emergence of a new paradigm referred to as the 'stakeholder theory of the firm'.

This new paradigm asserts that firm value is maximised by effectively managing the interests, concerns and incentives of all individuals who are stakeholders in a firm's success – shareholders, management, staff, the environment and society at large. Shareholder wealth is therefore maximised by addressing and motivating all stakeholders to seek the best possible outcome. A number of examples are often cited including:

- effective management of environmental impacts to mitigate costly regulatory shocks;
- safe working conditions and fair wages to improve labour productivity;
- building customer loyalty and brand value via community wide service and engagement; and
- having effective governance structures to aid decision making and overall firm management.

From this perspective, sustainability metrics capture the degree to which a firm addresses stakeholder interests. The stakeholder view suggests that good practices should ultimately be reflected in superior financial performance.[4]

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INCORPORATING SUSTAINABILITY WITHIN YOUR INVESTMENT APPROACH

Many approaches to incorporating sustainability in equity portfolios are based on a process of exclusion. This naturally stems from a principled position of not wanting to support companies involved in 'unacceptable' practices or products.

When considering exclusions based on sustainability grounds, investors should be aware of the risk that such exclusions introduce to their portfolio relative to standard benchmark portfolios. In some instances, the risk may be irrelevant and, based on principle, investors can simply reset their 'benchmark' to include only those companies that pass their sustainability tests. Alternatively, investors may consider a more activist approach. This could entail holding a below benchmark position in poorer rated companies and then using this shareholding to lobby management to make changes to its practices.

Whether investors exclude or down weight, there remains ample scope for active management to be overlaid to build new investment strategies. At Redpoint we believe that a range of investment disciplines can be applied to an investment universe of better EESG rated companies. Successfully meeting multiple investment objectives is not easy but certainly possible. Investors should clearly understand the interactions between:

- their own principled position with respect to sustainability
- their investment thesis of the return opportunity of focusing on sustainability, and
- other investment characteristics investors are seeking.

EASY AS ESG?

While 'ESG' sounds straightforward there are implications for investors that make it anything but easy.

Investors should carefully consider their objectives and reasons for potentially excluding companies from their portfolios. While absolute exclusions may be warranted in some cases, engagement with company management may be a valid approach in certain circumstances.

At Redpoint we believe that the ESG practices of companies can provide investment insight. We also understand that there are other well accepted and proven investment approaches. The challenge remains in trying to find better ways to understand and make the relevant trade-offs. This perspective can help to bring a better alignment between our investment objectives and principled beliefs. B

1. 'Theory of the Firm: management behaviour, agency costs and ownership structure', Jenson M and Meckling W, Journal of Financial Economics 3, 1976. **2.** 'New thinking on "shareholder primacy"', Stout LA, UCLA School of Law, Law-Econ Research Paper 11-04, 2011. **3.** 'Corporate governance and firm value: international evidence', Ammann M, Oesch D and Schmid M, SSRN, 2010. **4.** 'Shareholder value, stakeholder management, and social issues: what's the bottom line?', Hillman AJ and Klein G, Strategic Management Journal, 22, 2001.