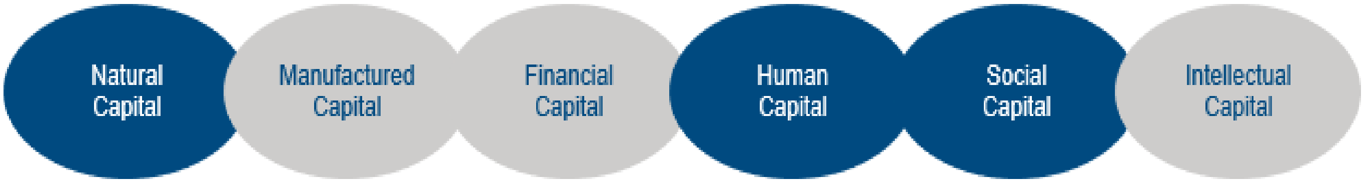
What exactly is ESG investing?

The latest TLA (three letter acronym) rolling off asset managers' tongues at every conference is ESG. Every manager claims to espouse the principles of ESG in their fundamental research process and when pressed for a sound bite to quote their adoption of ESG, one is offered a suspiciously similar paragraph from each manager that one suspects has been culled from an industry manual: their process is predicated on the success of long-term investing and the principles inculcated in ESG mirror the approach of that manager and their espousal of ESG principles will ensure the long-term generation of sound returns.

Then one looks at the top ten shares held and finds tobacco stocks (sell products that harm their customers), power utilities and heavy industry (despoil the environment) and companies whose shares have dropped by 90% due to shady governance.

To be quite clear, ESG stands for Environmental, Social and Governance, which align with three of the six pillars of capital on which any company stands – Natural Capital, Human Capital and Social Capital.



The other three - Manufactured Capital (what the company makes or does), Financial Capital (the income statement and balance sheet) and Intellectual Capital (patents, rights, R&D) - are the easy ones that are taught at universities and form the basis for the CFA Charter because one can easily put numbers to them.

However, the Environmental, Social and Governance pillars, being difficult to quantify, are largely ignored or at best paid lip-service, poorly as it turns out. This was demonstrated recently when a highly-regarded South African asset manager (who we won't name) admitted in public that their attention to Governance was extremely good but that their attention to "Ethics" and "Sustainability" were less good.

They didn't even know what the "E" and "S" stood for!

Typically, ESG investing involves some sort of filter and punishment for stocks that fail certain criteria. The "punishment" can range from a "stern engagement" with management to a more concrete refusal to buy the shares.

Proper ESG investing, however, should also involve an acknowledgement of the good that some companies do and overweight the angels as well as underweight the culprits. In the same way as many managers like to run a hedge fund so they can short the shares they do not like, sensible ESG investing should buy more of the stocks that are doing the right thing as well as less or none of the sinners.

It is highly probable that traditional asset managers simply do not possess the appropriate skill-sets to correctly assess the ESG criteria of the shares they analyse.

Hiring, as they do, accountants, engineers and highly numerate men and women, they may be poorly equipped to assess the softer credentials involved in ESG. Some of the factors, such as carbon emissions, strike days or deaths due to e.g. listeriosis or salmonella can be quantified, but the judgement of many of the other factors may require a skill-set different to the CFA charter.

MitonOptimal has broken new ground in South Africa by launching the first genuine ESG fund within which every single share on the Johannesburg Stock Exchange has been analysed according to over 140 ESG factors and where sinners are excluded (not underweighted) and angels are overweighted on the grounds that those are the shares that will be the winners in the future.

Furthermore, the fund is combined with a 25% fixed interest component (also ESG-based) so that retirement funds can comply with the regulatory requirements to invest according to ESG principles.

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