Valoris
Stewardship Catalysts

Why the Economist is wrong about ESG

July 27, 2022

Last week the Economist issued a special report about ESG[1] with the overall conclusion that "*ESG has too often been neither a good measurement tool nor an effective risk management one*." Based on this and other sweeping statements, the series of articles recommends to not only "simply" focus on the E, but further narrow the scope of the "E" to 'emissions only' and jettison all other ESG related topics.

The report exclusively focuses on public markets. We concur with much of the underlying analysis:

- The three letters do indeed "lump together a dizzying array of objectives that very rarely lead to one outcome"; not even within the category of the 'E';
- There is at least sometimes a trade-off between doing good and doing well but the investment industry is not always straight about this and its real incentives; and finally
- The rating issue: various scoring systems have different underlying policies, which lead to inconsistencies and gaming approaches such as summarized in the joke (or conventional wisdom) that *if as an (investee) company you are not happy with your ESG score, just change the service provider*.

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[1] ESG: Three letters that won't save the planet | Jul 23rd 2022 | The Economist

Investors are growing increasingly uncomfortable with the ESG label

Only a couple of weeks back we addressed several aspects of the above shortcomings in our initial blog post: "*Investors are growing increasingly uncomfortable with the ESG label*"[2]. The drastic conclusion of the Economist's special report, namely, to focus only on emissions going forward and drop the rest, justifies revisiting what is important about ESG.

Only a couple of weeks back we addressed several aspects of the above shortcomings in our initial blog post: "*Investors are growing increasingly uncomfortable with the ESG label*"[3]. The drastic conclusion of the Economist's special report, namely, to focus only on emissions going forward and drop the rest, justifies revisiting what is important about ESG.

Let's indeed first remind ourselves that the conceptualization of ESG — the lumping together of Environmental, Social and Governance considerations in the evaluation of businesses — mainly originated with the investment community. Investors know that good governance is positively associated with company performance and investment returns, especially in the long term. Investors have likewise come to understand that environmental and social factors may present businesses with severe, often catastrophic, risks. Even if these risks were not always properly assessed as part of due diligence and post-investment stewardship, they are nevertheless real or, in investor lingo, 'material' and the fact that there are many (and more than in the past) and that their materiality may be dynamic does not justify the conclusion to just focus on one singled-out aspect going forward.

The rationale for bundling together E, S and G has perhaps never been very apparent to the people who run companies. From the perspective of company managers, the term 'sustainability' may be more useful to describe an entire approach to running a business to make it more likely to survive and prosper in the long run. Yet, within the broad topic areas of ESG—and on the Venn diagram with sustainability—lie many, long-recognized top-level responsibilities such as CEO succession and compensation, compliance with environmental and safety regulations and supply chain management, with challenges around labor, waste minimization and management, and the

[2] Investors are growing increasingly uncomfortable with ESG label (valoriscatalysts.com)

sourcing of scarce resources. Ignoring these risks was and will continue to be the kind of failure that could even support a liability claim in some jurisdictions.[3]

Considering the Economist special report's main conclusion to focus on emissions only in light of the above indicates to us that a pure counting of carbon emissions at the cost of disregard of all other climate and ESG related issues – whether under such arguably problematic label or otherwise — risks creating perverse incentives. For example, a bank may drop portfolio companies because of their carbon footprint without feeling the need to engage with them regarding transition pathways, bringing them too early at the brink of loss of access to capital (and potential bankruptcy), ultimately contributing to destroying jobs. Job losses in turn will increase political opposition. In the European Union, the concerns facing workers in fossil fuel industries for example needed to be addressed by the Just Transition mechanism in the European Green Deal. All in all, the focus on carbon emissions only may lead to unwanted consequences that actually impede decarbonization, thereby bringing us to exactly the opposite of what most would consider a Just Transition.[4]

In the final article of the special report, the authors offer more realistic recommendations such as i) to focus disclosure on risks material to the industry at company level and ii) to customize investment product offerings to be better tailored to investor constituencies around the 'E', 'S' or the 'G' but to no longer cluster them together at investor level.

As concerns the first recommendation, and given the variety of topics linked to ESG, creating more focus through a materiality lens is never a bad idea, but the outcome of that focus may still mean in some cases that a company is confronted with a variety of climate, environmental, social and governance challenges all at the same time while in other cases it may allow for it to prioritize physical climate risks only or deal with the emissions in the supply chain first and foremost. Therefore, a narrower focus, such as just on emissions may not easily solve questions of prioritization and still leave the investor and the company with a high number of different ESG related challenges.

Regarding the second recommendation, we have always advocated the importance of unbundling ESG scores and thoughtful and judicious consideration of individual scores for 'E', 'S' and 'G'. Overall, trying to develop approaches and methodologies for assessing each of the E, S and G components—adjusted for materiality and harmonized—is the better way forward than engaging in discussions trying to discredit the whole concept of ESG and limiting it to narrow elements.

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[3] See for example A Board's Guide to Oversight of ESG (harvard.edu)
[4] See for example https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3962238.

We believe there are still promising possibilities for better ESG integration at investor level beyond what the Economist refers to as "a marketing hype and PR spin" if public market investors move beyond clustering portfolios around ESG scoring providers to performing their own meaningful analysis of ESG. ESG integration can be more sophisticated than just the blind use of ratings. Here, a lot could be learned from private markets where PE investors and development finance institutions in emerging markets involve specialists in the due diligence based on a well-defined investment policy and process description to thoroughly assess the material ESG risks with all its investments. This somewhat opposite approach to simply purchasing data and ratings also triggers its own challenges, but there is a middle ground that has not been fully explored by the industry, namely, to use the data of (maybe even more than) one service provider, but ultimately arrive at the investor's own informed analysis of what ESG-related risks are most material to the investment.

The subject matters bundled under ESG are indeed many and not all may be relevant to all companies at a specific point in time. The fact that they are many though is testimony to the complex times we are living in. The temptation to focus on just one or some of them is understandable, but naïve. This approach ignores inconvenient but unavoidable interdependencies. The complexity of our world can sometimes surpass our mental capacities and our emotional bandwidth[5]. This cognitive impact may explain the Economist's rather radical suggestion to limit the 'E' to emissions and get rid of the rest, but this is neither a realistic scenario nor a practical solution for the existing shortcomings of ESG.

[5] See in *Kegan/Lahey*, Immunity to Change: How to Overcome It and Unlock the Potential in Yourself and Your Organization (Leadership for the Common Good) (2009).

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Meet the founders:

Mike Lubrano, Managing Director

Over the past two decades, Mike has worked with scores of investors to integrate the consideration of ESG factors in their investment process and with company boards of directors to improve corporate governance, sustainability practices and transparency. He holds degrees from Harvard College (AB), Princeton University (MPA) and New York University School of Law (JD). He is co-author of ICGN's Governance, Stewardship and Sustainability, published in June 2021.

Mariangeles Camargo, Managing Director

Mariangeles has worked with financial institutions for almost two decades helping improve environmental and social performance, comply with regulatory requirements and respond to increasing expectations of stakeholders, including capital providers. She has extensive expertise in the development of green financial products. She holds a Master of Science in Finance from Bentley College, in Massachusetts, USA.

Martin Steindl, Managing Director

Martin brings over twenty years of experience leading initiatives and teams in FMO, the Dutch development bank, and IFC that helped streamline environmental, social and governance risk management processes when investing in financial institutions and private equity funds in emerging markets. Martin holds a PhD degree from the University of Vienna and Georgia State University and an MBA degree from the HEC School of Management in Paris.

Davit Karapetyan, Managing Director

Davit has more than 20 years experience designing ESG methodologies, tools and internal policies and procedures for institutional investors to apply in their investment and portfolio operations.

He helped develop International Finance Corporation's (IFC) corporate governance methodology, which is today widely used by many other development finance institutions (DFI) as well as private asset managers and private equity funds that are DFI investees. Davit's work includes crafting tailored ESG policies and procedures for a variety of investors to integrate corporate governance

and governance of sustainability analysis in investment and portfolio operations, sharevoting and nominee directorships. Davit has a Ph.D. in Law and is fluent in English and Russian.

About Valoris Stewardship Catalysts

A unique advisory services firm that helps investors and portfolio companies improve corporate governance, investor stewardship and sustainability performance in their operations. Valoris was founded by experienced practitioners in the fields of corporate governance, stewardship and environmental and social sustainability. Valoris serves institutional investors, impact funds, development finance institutions, financial institutions and their portfolio companies. Headquartered in Washington D.C. (USA) and Vienna (Austria), Valoris operates worldwide. www.valoriscatalysts.com