KNUFF & CO.
YOUR FAMILY OFFICE

On ESG Investing

By William G. Knuff, III

Copyright © 2021. All rights reserved.

It used to be called SRI or "socially-responsible investing". Today, it is called ESG or "environmental, social, and (corporate) governance" investing. Once eschewed by investment advisors and considered a hindrance to investment returns, ESG has become one of the trendiest marketing tools used by investment advisors to differentiate themselves with the immemorial goals of attracting and retaining clients. In fact, ESG investing has become so popular that: (a) several ESG research vendors offer myriad proprietary ratings and research; (b) many investment advisors now promote ESG as a uniform (i.e., "*one-size-fits-all*") investment strategy either directly to individual clients through a firm-managed portfolio or indirectly through ESG-focused mutual funds or ETFs; (c) an estimated $17.1 trillion[1] (~33%) of U.S. investment assets are professionally managed today using ESG guidelines or strategies, which represents a 25*x* increase over the past 25 years; and (d) regulatory agencies have begun to scrutinize firms espousing ESG services. I found this fact pattern intriguing and deserving of further exploration.

Conceptually, ESG investing is about owning companies that make positive, sustainable long-term impacts on both the environment and society through conscientious operational and governance practices. Environmental criteria consider such things as environmental impact and how a company performs as a steward of nature and natural resources. Social criteria consider how a company manages its relationships with customers, employees, suppliers, and other constituents. Corporate governance criteria consider such things as a company's audits, compensation, corporate policies, internal controls, leadership, and shareholders' rights.

Companies that receive better overall ESG ratings than their peers are ostensibly more deserving of the ESG moniker and better suited for inclusion in an ESG-sensitive portfolio. However, the criteria for each ESG category tend to be broad, subjective, and difficult to quantify. Thus, they create ample room for conflict and disagreement – especially between an investment advisor and its client when the former is promoting ESG investing as a uniform strategy and the latter views ESG investing as a way to express personal preferences in support of specific causes and companies. Compounding matters, no industrywide standards exist to define or measure ESG criteria and, so far, efforts undertaken to establish criteria appear to be flawed due to excessive reliance on artificial intelligence, which tends to produce irreconcilable results.

ESG criteria comparability also presents a challenge. While any given criterium (e.g., executive compensation) is fairly easy to compare among companies, different criteria are not so easy to compare, regardless of whether they fall within the same category or belong to different categories. Within the social category, for example, how should an investment advisor compare a company that treats its customers poorly to a company that treats its employees poorly? Analyzing different categories, such as social and environmental categories, how should an investment advisor compare a social media company that sells personal data instead of protects it to an oil company that flares natural gas instead of collects it? All else equal, which among these pairs of companies deserves a worse (or better) ESG rating? Moreover, should an investment advisor consider ESG ratings on an absolute or relative basis when determining which companies qualify? Tobacco companies tend to have worse ESG ratings (due to low environmental and social scores) than most other companies. In absolute terms, no tobacco company would qualify as an ESG investment. Is this appropriate or reasonable? Or, in relative terms, should the tobacco company with the best ESG rating among tobacco companies qualify as an ESG investment? There are no clear objective answers.

Should ESG investing be an actively managed *one-size-fits-all* investment strategy? Or, as an alternative to such an actively managed approach, can ESG investing be passively managed through a mutual fund or ETF? In my opinion, the answer to both of these questions is an obvious no. Given that ESG preferences are idiosyncratic and determined by the client, no single uniform ESG investment strategy (active or passive) can fit all sizes. Therefore, ESG cannot be aggregated into a single investment strategy of any kind. Further, given that ESG's inherent characteristics of comparability, measurability, and subjectivity render impractical the establishment of standard investment practices, it should not be and, by definition, cannot be an investment strategy.

Despite the weight of these realities, many investment advisors aggressively peddle ESG investing as an actively managed *one-size-fits-all* investment strategy. Why? For a handful of reasons that benefit investment advisors. One reason is client retention. It is easier and cheaper to keep an existing client, and thus preserve fee revenue, than it is to acquire a new client and new fee revenue. Successive generations, like Gen X and Millennial, have become very ESG conscious. As wealth passes to these generations, investment advisors have had to embrace ESG to keep these clients and their assets from seeking ESG-focused advisory services elsewhere. Another reason is competitive differentiation. To stay competitive and grow (assets and fee revenue), investment advisors must be able to differentiate their services to attract new clients. Still another reason is fee justification, or at least the mitigation of downward pressure on fees. In either case, the investment advisor is likely to point out that it is providing ESG services at no additional cost. However, this statement is plainly misleading because a *one-size-fits-all* ESG investment strategy, whether actively or passively managed, does indeed have additional (hidden) costs. Additional costs potentially include an extra layer of fees, foregone client-specific ESG preferences/goals, and foregone market-beating returns. Still, the perception of "free additional service" resonates with many clients.

Far from being an investment strategy, ESG investing is being used, arguably abused, by many investment advisors as a client and fee retention strategy. Hence, the regulatory focus. It would behoove clients to recognize this potential abuse when they are being wooed with ESG

investing services. If ESG investing is not an investment *strategy*, then how should one think about and apply it? It is useful and most appropriate to think of ESG investing as a client-directed and very client-specific investment *objective*. Like its more common investment objective brethren – e.g., capital appreciation/growth, income, return, and capital preservation – it reflects a client's investment preferences. However, unlike its objectively established brethren, it can only be established and applied subjectively… based on a client's mission statement which reflects its particular views and preferences with respect to ESG issues. Then, and only then, with a clean conscience, can it be considered ESG investing.

Source(s):

(1) *2020 Trends Report*, The Forum for Sustainable and Responsible Investments (U.S. SIF Foundation).