Is ESG finished?

Two of our analysts debate whether it's time to give up on ESG...

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ESG is over – Thomas McMahon

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I think there is a fundamental flaw to ESG investing which means it simply will not work. By ESG investing, I mean investing in equity markets based on the ESG rating of companies, or indeed funds. Let's overlook for one moment the bizarre uniting of environmental, social, and governance concerns into the same concept, the risks of which must be dawning on PR departments in the light of a certain recent medical evidence review (which Kepler is too sensible to even remotely imagine expressing an opinion on), and focus on the thing that most people care about when they talk about ESG—climate change. I don't think ESG investing can meaningfully contribute to reducing net carbon emissions.

Currently, there is a lot of talk in the investment community about the investment opportunity in the grid. Growth forecasts for AI and the data centres it will require, imply a huge surge in forecasted power needs. For example, the US recently upgraded its forecast for domestic power demand growth over the next five years from 2.6% p.a. to 4.7%, which amounts to a cumulative increase of 26% versus 14%. The US is ahead of the game on AI, and we should expect similar upgrades around the world. I think ESG investors should stop and think about this. It is Microsoft, Meta, and their ilk that are driving this demand growth by developing products that require huge amounts of energy. Fossil fuel producers are merely meeting the demand. If demand was lower, they would not drill and the fuel would not be burnt. Yet it is the fossil fuel producers that are being attacked by ESG investors while Microsoft, Meta, and other energy hogs are awarded the highest ESG ratings. These high ESG ratings have contributed to a lower cost of capital for these tech companies over the past five or ten years, and this has led to greater investments in their energy-demanding products. So it has been completely self-defeating. It is as if we were trying to stamp out drug use by making dealing illegal, but encouraging possession. Clearly, that would be absurd, so what's different with fossil fuels?

There is another way in which ESG investing has become self-defeating. The bull case for ESG would be that by investing in alignment and furtherance of climate change goals, investors can make money and contribute to those goals. But if fossil fuels are still investable by others, this won't work on either side. Post-pandemic, predictions of the pace of the path to net zero have been walked back, and there is still clearly a long period in which fossil fuel producers will be generating cash. Indeed, they may end up having an extraordinarily long twilight such as the one tobacco companies have enjoyed over the past 30 years, over which period, they made some famous equity income investors' careers (heroes and villains, as well as those who were both, or neither). All the entrenchment of ESG concerns in public markets will do is see the investment gains accrue to others, and maybe even allow those companies to take a more relaxed attitude to cleaning up their own operations.

An example of this process in action emerged last week in comments by Andrew Golden, the departing head of Princo, which runs the Princeton University endowment fund , during an interview with the FT. Noting that the decision to divest from publicly-traded fossil fuel producers, which he made in 2022, had hurt relative returns since, he added that Princo had continued to invest in private fossil fuel companies. In a way, I admire the brazen nature of this trade. However, in most cases, the investor in public and private markets won't be the same person, and most likely sovereign wealth funds, hedge funds, and others making money for the very rich will be the ones to enjoy the financial benefits of the energy producers facilitating the lives of the ordinary investors who have divested.

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To be clear, I am not suggesting any action to reduce emissions is fruitless. And there are clearly investment opportunities in renewable energy production, and maybe even nuclear or hydrogen in the fullness of time, at the right price. My argument though is that investors cannot solve this problem by divesting from fossil-fuel-linked companies and investing using ESG criteria, and by trying to do so they are making things worse. Reducing emissions requires government-led investment in alternatives and legislation. It isn't for asset managers or wealth managers to decide how to balance the improvements in our quality of life that AI can bring with the dangers of a changing climate. This is the realm of politics, where politicians are responsible, and where they are able to balance the shifting priorities of voters. Investors have a simple job and that is to make money. Fund flows show the truth of this, and they suggest investors are only interested in ESG funds when they are making more money than the alternatives.

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Thomas is Investment Trust Research Manager and joined Kepler in April 2018. Previously he was senior analyst at FE Invest, where he was responsible for fund selection for a range of model portfolios. He covered all asset classes over time, but has particular experience with emerging markets and fixed income as well as UK smaller companies funds. He has a degree in Philosophy from Warwick University and is a CFA charterholder.

ESG is only at the beginning – Alan Ray

First a disclosure: in my own investments, I overwhelmingly own ESG funds so I have 'skin in the game'. Without wishing to over-share, I would say I sit at the pragmatic end of the ESG spectrum, in many respects I see it as a pure investment decision based on superior returns, and in reality, many funds that are non-ESG specific are just fine by me.

Thomas and I are taking a big risk writing this article, as of course, it is a polarising debate and both of us have strong views which we've explored in many private conversations. So the good news is that we already know that we aren't going to fall out over our different views. Thomas's views don't, in my mind, really contradict anything I've said below, we just look at it through different lenses.
In life and finances, so many arguments are constructed around a 'balance sheet date'. It's necessary for the limited processing power of my brain at least to look at a snapshot of things and reach a conclusion. A great deal of financial analysis is based on this even though its authors and readers understand it to be only a partial picture. We, therefore, tend to presuppose that what we find, at any given point in time, is the last word on the subject.

One of the very big problems with ESG is that it is inextricably linked with ethics, even though strictly speaking the ESG framework is designed to be as much as possible quantitative, one can't really get around the fact that it carries a heavy qualitative burden, and that's where the trouble really starts. A brief example will show how difficult it is to get an 'ethical' outcome from an investment. If one accepts the narrative that offshore wind is an important future source of energy, either for climate change reasons, security reasons, or both, then it seems to me this is an investment suitable for an ESG mandate under conventional measures of what ESG is trying to achieve. Offshore wind, of course, sits at the end of increasingly long cables under the sea constructed without much thought to security and yet there is a rising acknowledgement in defence circles that undersea cables are at risk of interference from, well, you probably know who.

It seems likely then that any review of the defence needs of the UK, and indeed quite a bit of NATO, should prioritise defending against this as a strategic goal, in the same way as surely every conventional power station is marked on a map somewhere in an RAF control room as a strategic asset today, and one assumes the same is already true of the UK's offshore wind assets. It's difficult to defend against an undersea enemy with an RAF Typhoon though, I would imagine. Presumably, we need some different bits of kit for this task. Does that then mean that defence spending is now ethical? And should ESG funds now be lifting restrictions on owning defence companies? As far as I know, ESG funds are as yet, not accepting of such an argument, and yet I have no problem seeing this as a conclusion that fits my own ethics and I daresay those of many others. But what I think isn't really the point. This is just one example plucked from the air that shows the impossibility of matching ethics to investment.

But here's the thing. In our jobs we naturally get to listen to a lot of fund managers discussing all kinds of topics and our readers can be sure that we've all heard plenty of very passionate monologues against the foolishness of ESG and how it leads to misallocation of capital. On every single occasion though, those monologues feature examples of companies that are doing a great deal to improve their ESG credentials, but the 'madness' of ESG means they are still excluded from ESG funds. We don't need stock examples here, but readers will likely have a good sense of which

oil company is reinvesting the most capital into renewable energy and decarbonisation. They may have less of a sense of the leading cement company, or glass manufacturer, where energy usage and recycling are prioritised, profitably, and yet again, the ESG fruitcakes still won't buy them. Or the copper and lithium miners that provide the fundamental building blocks for the energy transition. I would point to every one of the European equity trusts, large- and small-cap, as owning investments that are either delivering on or expected to deliver on outcomes that are linked to ESG, but picking some examples: **Henderson European Focus Trust's (HEFT)** investment in cement and oil, the turbocharger company owned by **European Assets (EAT)** that reduces maritime emissions, **Fidelity European Trust's (FEV)** holding in a deep mining drilling equipment company that allows us to go further and deeper for the elements needed to sustain the energy transition and **JPMorgan European Discovery's (JEDT)** recycling glass manufacturer. And of course, **BlackRock World Mining (BRWM)** owns many mining firms inextricably linked to global environmental outcomes. The ESG debate has shaped the way these fund managers have allocated capital, even if they aren't, in a narrow, technical sense, ESG investors.

We've all read those outraged articles about how this government or that minister has privately discussed doing something very controversial. I don't know about you, but I think that if you can't have a private conversation where you throw controversial ideas around as part of a debate, then how will any sensible conclusions ever be reached? ESG doesn't have the luxury of having a private conversation, so it has always been subject to clickbait opinion pieces and strong opposing views even though it's a massive experiment conducted in public. But those strong opposing views are helping shape what's next, and driving the behaviour of non-ESG managers in a direction that ESG investors should be happy about, and so the idea that ESG is a failure presupposes that the desired outcome of the experiment is that there are ESG funds for those that care, and non-ESG funds for those that don't. That's a false premise unless you work in a funds marketing department, and I would challenge any marketing department to launch a fund on the premise that 'we're going to buy up the cheapest, most unethical, polluting companies in the world in one big portfolio' and see how far they get. ESG funds may not all be a success in themselves, but ESG has shaped the debate for everyone and when I listen to a non-ESG fund manager patiently explain why they have allocated capital to this company or that company, and yet still those ESG do-gooders won't buy it, I think 'good, it's working'.

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Alan joined Kepler in October 2022. He has worked in the investment funds industry for over 25 years. The first half of his career was as an investment trust analyst, leading a highly-rated sell-side research team. More recently he has worked in corporate advisory and investment banking roles, with a focus on alternative asset classes.

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