The Elephant in the Room: the Contradiction within ESG

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We all agree that finance has a key role to play in getting us to net zero. But we can't ignore the elephant in the room: the inherent conflict between the "E," the "S," and the "G" in environmental, social, and governance (ESG) investing.

As much as we might wish otherwise, the goals embedded in these initials don't always align with one another. That's why a compromise must be made. Investors, asset managers, and businesses have to agree on which of the three is the most important.

So, what's our position at SustainFinance? We believe social, the "S," should be the highest priority. Why? Because sustainability is all about humanity.

The "S" factor is broad. It varies by country, culture, and context. Figuring out how these can be lined up within the boundaries of net-zero goals must come down to people.

Someone ultimately has to pay

There is a huge challenge in pushing manufacturers on tight margins to spend money on cutting their greenhouse gas emissions. This has consequences elsewhere.

Let's make this real. Providing a safe environment, a living wage and good workers' rights costs money. Clients want this, but still want a reasonable price. The same goes for investors. They want to know their money is channeled to good companies who treat their workers well. They also want good investment returns. However, at the end of the day someone has to pay.

To reduce emissions, companies are likely to have less profits initially to pay out as dividends to shareholders. Falling dividends usually see companies' share price fall. Both potentially hurt returns for those saving for retirement, or the ability of parents saving for their children's education, to give two simple examples.

This means aligning multiple interests – investors, asset managers and businesses are ultimately all about people; so it requires a shift in thinking away from focusing on environmental issues in isolation, to thinking about outcomes from a broad social perspective. In a post pandemic world which needs to scale to create change, the ramifications are huge.

Investors' primary desire for returns

When discussing future liabilities (retirement, education, et al) the pressure is on investors to achieve their required returns.

Usually, they are focused on accumulation or income generation, which drives the prices of the assets being sought. Those seeking income to help fund retirement typically chase high dividend paying companies, especially in the ongoing low interest rate environment. Investors are also increasingly using income-generating companies for compounding to generate capital growth.

In Asia, many companies pay out a high percentage of profits as dividends. Reducing profits, and therefore dividend payments, to invest in their business means the market will punish them. Investors focused on income-stocks will move elsewhere. The challenge of sustainability is that the companies that pay the highest dividends are typically in traditional industries that are asset heavy and have a high carbon footprint. Investors will need to support them in their transition to NetZero by accepting lower dividend payouts, otherwise these companies will struggle and eventually lose out as we transition to low carbon alternatives. Whilst this may be desirable in the long-term , in the short term it will create unmanageable economic dislocation.

Fund managers under pressure to maintain performance and deliver green

The key challenge facing the asset management industry is that it operates in a saturated market, that is highly competitive.

Fund managers are traditionally judged primarily on performance. However, the managers' response to ESG and their ability to incorporate ESG factors is now another area of competitive pressure.

The question is how to maintain performance while still addressing ESG. Yes, ESG strategies outperformed in 2020, and demonstrated sustainability can now be lucrative. However, upon digging deeper, it is apparent that positively screened ESG companies have lower employee metrics and are asset light industries. Automation does not create jobs, and tech does not need employee rights.

Investing in large ESG positive businesses also has the destructive effect of channelling money away from asset heavy industries that today create jobs and support local communities. Equally, SMEs that score low on ESG need to finance their NetZero transition – is the market punishing them or helping them?

Businesses are at the sharp end

Companies must tread a fine line. They are expected to deliver returns, while at the same time investing for their future. Sustainability is no longer a nice-to-have overhead, it is future-proofing their business.

However, delivering on the 'E' is going to cost money, and as with other stakeholders, someone has to pay. If the cost cannot be passed through to the end customer, cutting costs within the business may impact staff pay, bonuses and the ability to hire new employees. It may also lead to certain functions becoming obsolete and job losses. The 'E' comes at the expense of the 'S'.

In Asia, the objective used to be squeezing the last drop of profit out of the business. This is slowly shifting to an objective of longevity and legacy. Paying out all profits in dividends is short-sighted, whilst playing the long game could help increase margins over time. To do this, the companies need the right investors onboard.

Conclusion

For stakeholders who are used to only thinking from one quarter to the next, a mindset shift is needed to build longer term relationships and expectations, and move away from get-rich-quick investing.

Generating returns and being true to the 'S' takes time. Short termism is the death knell of sustainable growth, so companies need the right type of investors with the right mindset to achieve the change needed.

Now is the time to be making that mindset shift, which will help identify investments in companies that stand to do best from the transition to a low carbon future alongside broader social objectives of communities and economies.