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INSIGHTS FROM CFA SOCIETY SINGAPORE

The elephant in the room: the ESG contradiction

The goals embedded in ESG do not always align with one another, hence a compromise must be made

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

As much as we might wish otherwise, the goals embedded in these initials do not always align with one another. That is 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 is our position? We believe social or 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

Convincing manufacturers on tight margins to spend money to cut their greenhouse gas emissions is an enormous challenge. It comes with consequences.

Let us make this real: A healthy environment, a living wage, and strong workers' rights cost money. Clients want these outcomes, but at a reasonable price. The same goes for investors. They want their money channelled to good companies that treat their workers well. And they want good investment returns. But at the end of the day, none of this is free.

To reduce emissions, companies may have to sacrifice the profits they pay out as dividends to shareholders – at least at first. With falling dividends come falling share prices, and both hurt the returns of those saving for retirement or for



Part of the sustainability challenge is that the highest dividend companies are often in traditional, asset-heavy industries with large carbon footprints. To support them in their net-zero transition, investors will have to accept lower dividend payouts, otherwise these companies will not survive the move to low carbon alternatives. PHOTO: REUTERS

their children's education.

This means we have to align multiple interests. Investors, asset managers and businesses are ultimately all about people. So we have to shift our thinking away from a focus on environmental issues in isolation and towards a more holistic approach that looks at outcomes from a broad social perspective. In a post-pandemic world, this reset has huge ramifications.

Investors want returns

When it comes to future liabilities – retirement, education, et cetera – the pressure is on investors to achieve their required returns.

Their usual focus is on accumu-

lation or income generation. This drives the prices of the assets being sought. Those seeking income to fund their retirements will chase high-dividend paying companies, especially in the current low interest rate environment.

In Asia, many companies pay out much of their profits as dividends. If they reduce profits, and therefore dividend payments, to invest in greening their businesses, the market will punish them. Investors focused on income stocks will take their money elsewhere.

Part of the sustainability challenge is that the highest dividend companies are often in traditional,

asset-heavy industries with large carbon footprints. To support them in their net-zero transition, investors will have to accept lower dividend payouts, otherwise these companies will not survive the move to low carbon alternatives.

While this green transition is desirable over the long term, in the short term it may create unmanageable economic dislocation.

The major challenge for the asset management industry is the saturated, highly competitive market in which it operates. Fund managers are traditionally judged on performance. Now, however, their ability to incorporate ESG factors is

another area of competitive pressure. How do they maintain performance while also meeting expectations around ESG?

Yes, ESG strategies outperformed in 2020, and demonstrated that sustainability can generate returns. But digging deeper, the data indicates that positively screened ESG companies have lower employee metrics and tend to be asset-light industries. Automation does not create jobs and white-collar tech workers do not need the same protections as those on an assembly line.

Investing in large ESG-positive businesses also has a destructive ef-

fect. It channels money away from asset-heavy and job-creating industries that support local communities. And what about small and medium-sized enterprises (SMEs) that score low on ESG and need to finance their net-zero transition? Is the market punishing or helping them?

Businesses are at the sharp end

Companies must tread a fine line. They must keep their business profitable in the near term while investing in going green over the long term. Sustainability is no longer a nice-to-have accessory, it is a way to future-proof their business.

But delivering on the E is expensive. If the cost cannot be passed on to the end customer, it will have to come out of the business, whether in staff salaries, bonuses, or head count. It may also render certain functions – and jobs – obsolete. The E comes at the expense of the S.

In Asia, the objective used to be to squeeze the last drop of profit out of the business. Now it is slowly shifting to longevity and legacy. Paying out all profits in dividends is short-sighted, while playing the long game may increase margins over time. To accomplish this, companies need the right investors.

What's next?

Stakeholders have to dispense with the quarterly mindset and build longer-term relationships and expectations. They need to move away from get-rich-quick investing. Generating returns and being true to the S takes time.

Short-termism is the antithesis of sustainable growth. For companies to meet the net-zero challenge, they need investors who understand what is at stake and what it will take to achieve. Now is the time to acknowledge the elephant in the room and start making that mindset shift. And that means embracing the S in ESG.

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