Published Date: May 7th, 2022

What Ted's Thinking

What's in a Name? The Problem with ESG

"Listen closely to the words I lay. It's all about the wordplay."
- Jason Mraz

Catchy phrases for investment themes can drive significant fund flows. In 2001 Jim O'Neill at Goldman Sachs coined the term "BRICs," which catalyzed a surge of interest in equities from Brazil, Russia, India, and China. In 2013 Jim Cramer started referring to "FANG" stocks (Facebook, Amazon, Netflix, and Google), which he soon revised to "FAANG" (including Apple), and later "FANMAG" to make sure Microsoft was in the mix. Charley Ellis shared the best terminology in investment history during our podcast conversation: "Life Insurance." After all, no one wants to buy "Death Insurance," which is what the policy actually covers. Charley also has a distaste for the label "Passive" investing, describing that nobody wants to be passive - as an investor, in life, and especially in bed!

Sustainable investing has its own semantics, each with quirks in meaning and implementation. A team at the United Nations created the acronym "ESG" in 2004, which grew into prominence after fifteen-year-old Greta Thunberg gave a speech at the United Nations in 2018 that became the tipping point for climate activism. "ESG" is about as effective in quality as "BRICs" and "FANG," and a far cry from "Life Insurance." E, S, and G are three mutually exclusive attributes of companies that can conflict when

shoved together. What are we to make of a company producing a once-in-a-lifetime, game changing clean technology that is run by a bunch of white males and overseen by a crony Board of Directors comprised of more white males? Is the company good or bad from an ESG perspective? Or how about revolutionary electric car company Tesla getting removed from the S&P 500 ESG Index for subpar worker conditions when oil major Exxon is rated in the top ten?[1]

Despite its flaws, ESG has a first-mover advantage. Investments helping to save the planet or make life better are the fasting growing segment of global financial services. It's no surprise that index and ETF providers rushed to meet this demand through the creation of ESG products. According to Bloomberg, some 160 providers lined up to sell sustainability ratings and data to money managers well before a commonly accepted definition existed. Bloomberg took MSCI to town by deconstructing its ESG index to show that there is virtually no connection between MSCI's "Better World" marketing and its index methodology.[2] With such a broad remit and a lack of consistent data, perhaps it's also not a surprise that no two ESG indexes look alike. Much to my chagrin, "ESG" is here to stay and probably will have as long legs as the horribly constructed "Dow Jones Industrial Average."[3]

"Impact investing" is a marketing phrase that packs a punch right up there with "Life Insurance" and "Active Investing" in the terminology Hall of Fame. Everyone wants to have an impact – on returns, on the people around them, and on the world. Can anyone disagree? After all, what is the opposite of impact investing? Selfishly making money for yourself.

"Sustainable Investing" is a robust expression of aspiration. It causes you to stop and think, akin to Daniel Kahneman's System 2 thinking. The term calls to mind the quality risk factor, implying long duration, consistent of cash flows on the income statement, and a holistic approach to achieving those cash flows as a business. "Sustainable Investing" is a big improvement from "ESG," although it may be even harder to define characteristics of a sustainable company.

When it comes to turning nomenclature into portfolios, institutional allocators have mostly laughed at ESG indexes and taken a methodical approach to articulate the philosophy, measurement, and implementation of sustainable investing that best suits their constituents.

For the last few years, every institution in every boardroom discussed "Divestment" from fossil fuels. Europe led the way and last fall Harvard University announced it would stop

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1 "Musk Says ESG 'An Outrageous Scam' After Tesla Index Exclusion," Bloomberg, May 18, 2022

2 "The ESG Mirage," Cam Simpson, Akshat Rathi, and Saijel Kishan, December 10, 2021. https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/

3 The Dow Jones Industrial Average (DJIA) is calculated by taking the average price of the 30 stocks in the index adjusted by a divisor that accounts for stock splits and mergers. The weighting is indeed based on stock price, not market cap, fundamental value, or anything that sensibly matters in investing.

investing.[4] But a funny thing happened on the way to mass adoption of Divestment. Not long before Harvard's marquee announcement, oil prices awoke from a five-year slumber as the market recognized the need for fossil fuels to effect energy transition. When Russia invaded Ukraine, the price of oil soared and the rest of the world, especially the divestment-leading EU, struggled to reconcile sanctions with energy needs.

As a result, the boardroom conversation shifted. "Divestment" has all but disappeared and been replaced by "Net Zero" emissions. My hunch is that institutions who already divested will not turn back, but the rest will follow Seth Alexander's lead at MIT, who articulated the following thoughtful, holistic approach to MIT's dismissing of Divestment in favor of Net Zero.

Some people in the MIT community have suggested that MIT divest from fossil fuel companies. We prefer the net-zero approach instead for several reasons. First, it encompasses the whole energy system rather than simply targeting the producers of fossil fuels. Second, we believe divestment could lead to fossil fuel holdings moving into the hands of investors who do not care about climate issues and thereby preclude the opportunity for constructive engagement with companies about their climate policies. Third, the net-zero approach acknowledges the need for an energy transition in which fossil fuel use is phased out as rapidly as possible, rather than assuming we can shut off fossil fuel investment today without any unintended impact on life's necessities such as heat, electricity, and the production of agricultural fertilizer products.[5]

"Diversity and Inclusion" has also passed a tipping point. If Greta Thunberg was the icon for the environment, George Floyd was the catalyst for D&I. The trend towards a more representative workforce is a directional arrow of progress many decades in the making. It has impacted everything from college admissions to job recruiting, retention, and promotion practices.

We still have a long way to go to integrate D&I in portfolios. Institutional allocators have taken a System 1 reaction to D&I by searching for and adding a diverse-owned manager to their roster. This strikes me as a short-term solution to a deep-seated problem. Almost by definition, the very industry that eschewed diversity in the past does not currently offer a broad array of investment options among diverse-led asset managers. One or two adds feels more like window dressing than the solution to a problem.

Addressing D&I in asset management will take time, and the foundation is getting laid. Asset management is concentrated industry across most asset classes, so it is incumbent on the winners to hire and train the next generation of leaders. We are seeing progress on that front led by initiatives like the Kellogg Foundation's Expanding Equity program, industry leaders like Shundrawn Thomas, and hiring practices of large

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[4] https://www.npr.org/2021/09/10/1035901596/harvard-university-end-investment-fossil-fuel-industry-climate-change-activism

[5] https://mitimco.org/wp-content/uploads/2022/04/MITIMCo-15-Year-Letter.pdf

asset managers. A decade or two from now, we will see more diverse participants in the industry spinning out of brand name organizations with first class training and pedigree. Until then, patience is required to achieve a more sustainable workforce.

Words matter. Semantics creates structure in our industry and leads to the formation of products and fund flows. These issues are too important to get mired in an ill-conceived naming convention like ESG, but at least the conversation among allocators is happening daily and moving in the right direction.

I advise managers and allocators to adopt "Impact Investing" focused on "Sustainability." I'm not sure how that translates to an investment strategy, but it sure sounds good.