

A MATTER OF ETHICAL INVESTMENT

WHY ESG SHOULD BE ON TOP OF OUR SOCIAL AND POLITICAL AGENDA

Ethical investment has been seen either as the preserve of the virtuous, unconnected to the real world or as largely a box-ticking exercise. But some of the world's largest investors have become radicalised and are intent on forcing companies to behave ethically; recalcitrant corporations caught in their crosshairs should be concerned. What has brought about this change?

▶ Nick Silver

FOR MANY YEARS EXXON MOBIL HAS DENIED THAT CLIMATE CHANGE WOULD AFFECT ITS BUSINESS, BUT WHILST DONALD TRUMP WAS PULLING THE US OUT OF THE PARIS AGREEMENT, SHAREHOLDERS WERE COMPELLING EXXON TO COME CLEAN ON THE TRUE IMPACT OF CLIMATE CHANGE ON ITS OPERATIONS AND OUTLOOK.

This is just the start: in 2019 investors have committed to voting down company boards on a range of social issues; boards should be worried if they do not have a serious climate change policy, if they pay themselves too much or if less than 30 per cent of them are female.

Since Socially Responsible Investment's (SRI) origins in avoiding 'sin' stocks, (such as gambling and tobacco) the number of issues covered by SRI (also termed ESG; environmental, social and governance) has mushroomed. It has two main strategies: dis-investment (not investing in 'bad' stocks) or engagement (using ownership to get companies to change behaviour).

The most significant ESG issue currently is climate change. Co-ordinated actions by investors are being backed by regulators, forcing companies to change their behaviour.

The main progress has been on disclosure. Companies have been voluntarily disclosing carbon emissions but information has not been adequate; it's not comparable and does not satisfactorily cover risk.

Recently the Financial Standards Board (FSB) has developed standards for companies' reporting, supported by 500 of the world's largest companies, with many more reporting in line with recommendations.

The EU Commission have proposed to further ratchet up pressure by making this disclosure mandatory, where the EU leads other countries tend to follow. The EU have also committed to a taxonomy and benchmark on green finance and prescribing how risks should be managed.

Risk disclosure itself can change how companies behave. But compared to the drastic action we need to take on climate change this has been wholly inadequate so far. However, stronger levers are starting to be deployed and their ramifications will be felt over the coming year.

Investors are starting to flex their muscles; not small specialist houses but the likes of LGIM, one of Europe's largest. LGIM have committed to name and shame poorly performing companies, and vote against company boards whose progress on climate change is insufficient. They will also vote against boards who have less than 30 per cent female representation. These are activist stances well beyond what could have been envisaged a few years ago.

The EU are also considering introducing regulatory support for green investment by banks and insurers – making these institutions favour green over other assets.

What are the drivers of this ramping up of activity? It is a mixture of a change in culture and intellectual approach along with the belated realisation by investors and governments that we need to take rapid action and that finance is part of the solution.

SRI has become part of marketing strategy for investors; it fits well with an image of being responsible long-term and it's much easier to talk to customers on stuff they can understand like whether their pension is green or gender diverse, than boring financial details. Millennials are more concerned about ethical issues than previous generations, and extend that concern to their finances.

Conventional wisdom used to be that ethical investment meant sacrificing financial returns, but now there is ample evidence to the contrary which should turn conventional wisdom on its head - why would you not invest ethically if you can achieve the same financial returns?

More generally this is part of an intellectual backlash, following the 2008 financial crisis, against the dominant economic theories that the market is omnipotent; meaning that ESG factors, once dismissed as irrelevant, are taken much more seriously.

Stock market indices are effectively backward looking, as they are invested in existing



companies. A rapid shift out of fossil fuels into clean energy would mean that investment portfolios are too heavily invested in the old economy; green investment provides a hedge.

However, I don't want to paint too optimistic a picture.

I have focused on climate change but the wide church of activities within ESG creates tensions. For example, Tesla is seen to be 'green' as it makes electric cars but its governance has been criticised. Measurement of ESG outcomes is difficult and problematic.

There has recently been quite a lot of progress on gender issues by LGIM and other investors, but maybe because this is an in-vogue issue, like pay-inequality or use of plastics. Also, the investors themselves are open to charges of hypocrisy; often they are mostly male and have high gender pay gaps.

ESG is criticised as a box-ticking exercise, with companies complying with policies and requesting disclosure without any real action. Widespread acceptance of ESG has given way to progress. As the mainstream all signs up for ESG, pioneers like LGIM have a licence to push the boundaries. Also, by signing up to initiatives investors can be held to account; for example, BlackRock was criticised for voting with Exxon management on climate change contradicting its publicly stated position. The following year it changed its vote.

As well as investing heavily in clean energy, which is happening, to avoid dangerous climate change we have to leave a load of fossil fuel assets in the ground. These assets are of great value and someone has to take the hit from their loss; I have seen no plan for who is going to pay for this.

The proof of the pudding is in the eating. Scientists have warned us we only have 12 years to take drastic action which needs a massive reallocation of capital. Does ESG investment look like it can get anywhere near achieving this? Despite the progress, the answer is definitely not. ●

Nick Silver is co-founder and director of Radix and the Climate Bonds Initiative, and author of *Finance, Society and Sustainability*. Radix is the think tank for the radical centre, aiming to re-imagine politics to embrace technology, innovation and social change.

