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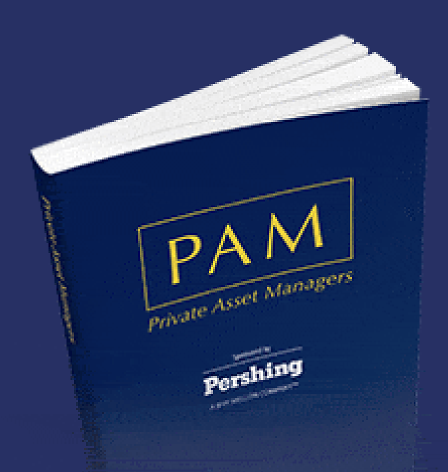

ESG investing: Time to let go of the myths

RICHARD BURRETT, 12/02/2020

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By Richard Burrett, chief sustainability officer, Earth Capital

As we enter a new year and a new decade, an opportunity presents itself to reflect on the way in which environmental, social and governance (ESG) investing has evolved over the last 10 years.

It is difficult to remember exactly how many times I have been told that ESG or impact investing is "going mainstream" – certainly enough to retire altogether if I had a penny with each statement.

The same could be said for every time I have heard someone say that ESG is a fad and will be forgotten soon enough. The truth can, as usual, be found somewhere in the middle.

The responsible investment sector has come on in leaps and bounds, with interest increasing sharply due to environmental watershed moments during the last decade – starting with the shocking scenes of the Deepwater Horizon oil spill in 2010 and ending with the fires tearing through the Amazon rainforest in 2019.

Even 2020 has begun with devastating bushfires which are still wreaking havoc throughout Australia as you read this.

It is appropriate that we have moved out of the "teen" years and into 2020 since it is fair to say that sustainable investing is no longer the adolescent of the financial world.

Investors and consumers alike are rightly demanding to know what businesses are doing about the impact they have on the wider environment around them.

Yet despite methods such as ESG and impact investing coming into their own as an investment strategy, many participants remain resistant to change, still clinging to the same misconceptions and hindering wider adoption of this exciting discipline:

"Adopting responsible investment strategies comes at the cost of profits"

This is perhaps the biggest and most damaging of misunderstandings around responsible investing in general, so it is only right to start here.

The very idea that doing good cannot possibly result in a healthy investment return is simply false and stems from the memory of investors getting their fingers burnt when renewable energy investments – chiefly solar and wind energy – resulted in heavy losses during the early part of the last decade.

When ESG was in its infancy, there were admittedly rather limited options for investors and the understanding of what constituted an 'ethical,' 'green,' or 'responsible' investment was lacking in sophistication.

Many investors were often keen to simply tick the ethical box and entered these investments without perhaps truly understanding the underlying risks associated with certain assets.

Whilst it is vital to bear these important lessons in mind, things have thankfully moved on considerably.

Sustainable investing has come of age, along with our understanding of how to apply it properly. Investors are also beginning to understand the "value at risk" from investment in unsustainable business models.

In many ways, applying an ESG screen has proven to be an excellent way of identifying robust, profitable companies that can outperform their peers. At Earth Capital we have certainly found time and time again that screening with an ESG lens reduces risk, yields stronger investee companies and, ultimately, stronger returns – social responsibility doesn't necessarily need to come into it when 73 percent of ESG screened funds outperform their non-ESG equivalents, according to Interactive Investor.

Our view is that full integration of an ESG screening process is a logical component of investment due diligence.

"Sustainability cannot be properly measured"

This was perhaps true in the early days of sustainable investing; however, we are now seeing the rise of impact metrics being developed in order to demonstrate an ecological return to investors alongside a financial one.

This is an important step in the right direction but there is still work to be done before the industry can even come close to adopting a solid universal system of standards for impact reporting.

Currently, impact investors rely on bespoke KPIs that have usually been designed to suit their particular method of ESG investing.

Worryingly, these impact metrics can often disguise less than flattering outcomes – for example, much has been made of the electric vehicle sector in the push to reduce carbon emissions.

Whilst it is true that EVs could have a hugely positive impact on the reduction of CO2 overall, it is important to remember that electric cars are powered by batteries that contain lithium, a substance that is often mined using methods that might not necessarily be considered environmentally-friendly.

At Earth Capital, we have developed the trademarked Earth Dividend tool, a system which calculates the net impact of businesses, taking into account the whole value chain, covering natural and ecosystem resources, social and economic impact, pollution and society and governance outcomes.

True sustainable development can only be achieved by understanding the holistic footprint of a business and this starts with uncovering the negative effects as well as the positive ones. We only invest in companies that we believe can deliver a net positive Earth Dividend score within two years and spend a lot of time working with businesses to help them understand firstly *how* their business model has an impact, and secondly helping them to *mitigate* this impact in favour of more sustainable business practices.

"ESG investing is only about the environment – it is too narrow"

The environment is an emotive and controversial topic which, understandably, garners the most column inches.

The BBC series Blue Planet II chose well in exposing the problem of plastic pollution due to the arresting visual effect of a pile of garbage in the middle of the ocean, which ultimately ended up going viral and placed plastic consumption top of the list of conversation topics around the dinner table.

Still, there is an entire spectrum of sustainable investment that does not focus on environmental issues – indeed the social and governance components of ESG are frequently overlooked yet offer rich and diverse opportunities for investors.

One example of this is data security technology. This is an area which may not spring to mind when thinking about ESG, but as we move towards an increasingly online world where personal information is frequently hacked and fraud has become commonplace, responsible stewardship of data has become extremely important from a governance point of view.

Technology firms are major innovators - for example, at Earth Capital we have invested in SoftIron, an energy-efficient, wire-speed storage solution provider. SoftIron produces hyperconverged, software-defined storage and transcoding devices.

Not only do they control 100 percent of the entire design and build process, but they manufacture and assemble all the products in-house, including electronics subassemblies. The result is auditable provenance on all of their data centre appliances – the foundation of true security – and SoftIron have identified that they are the only manufacturer of this.

Despite environmental setbacks, 2020 and beyond looks to be an exciting decade for the world of responsible investment across the entire asset spectrum.

We have seen significant companies shift from simply paying lip service over carbon emission targets to building entire teams in-house dedicated to sustainability.

Investors of all ages and demographics are sitting up and taking notice of companies who can demonstrate leadership on these issues, perhaps indicating that it is time for the global market to let go of unfounded anti-ESG myths once and for all.

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