ESG Is For Everyone

BY: **RANJAN BHADURI & JOANNA HAN**

Walter Gretzky, the father of perhaps the greatest hockey player of all-time, gave his son Wayne some sage advice when he was just three years old:

"Skate to where the puck is going to be, not to where it has been."

Unlike most children that chased the puck around the rink, Gretzky learned to anticipate where the puck would end up and the rest is hockey history. The quote has wisdom that can be applied in finance: don't just follow the herd or chase returns. The problem with this quote though is that most people do not have the brilliance of Wayne Gretzky. It is usually exceedingly difficult to know where the puck is going to be. ESG (environmental, social, and governance) gives the finance community the unusual opportunity of being told this.

ESG is where the puck is going to go.

Popular Fad

At first, it may have seemed like just the latest popular fad, but evidence has shown it is most definitely not just a passing trend, but the direction of our future. Following the pandemic, public priority has now rapidly shifted towards environmental awareness, social justice, and especially crisis management, resulting in numerous sustainability topics moving to the top of social, economic, and political agendas.

The United Nations has created the Principles for Responsible Investing (PRI) which incorporate ESG factors. Since asset owners, investment managers, and service providers are signatories of the PRI, this represents a significant public commitment as the deepest pockets are heading towards ESG. "As a global pension plan, we will leverage our scale and influence to transition to a low-carbon economy and create a sustainable climate future," says Jo Taylor, president and CEO of the Ontario Teachers' Pension Plan. "With co-ordinated action, net-zero by 2050 is an ambitious, but achievable goal. We are committed to playing our part alongside other organizations and governments around the world to effect significant, positive change."

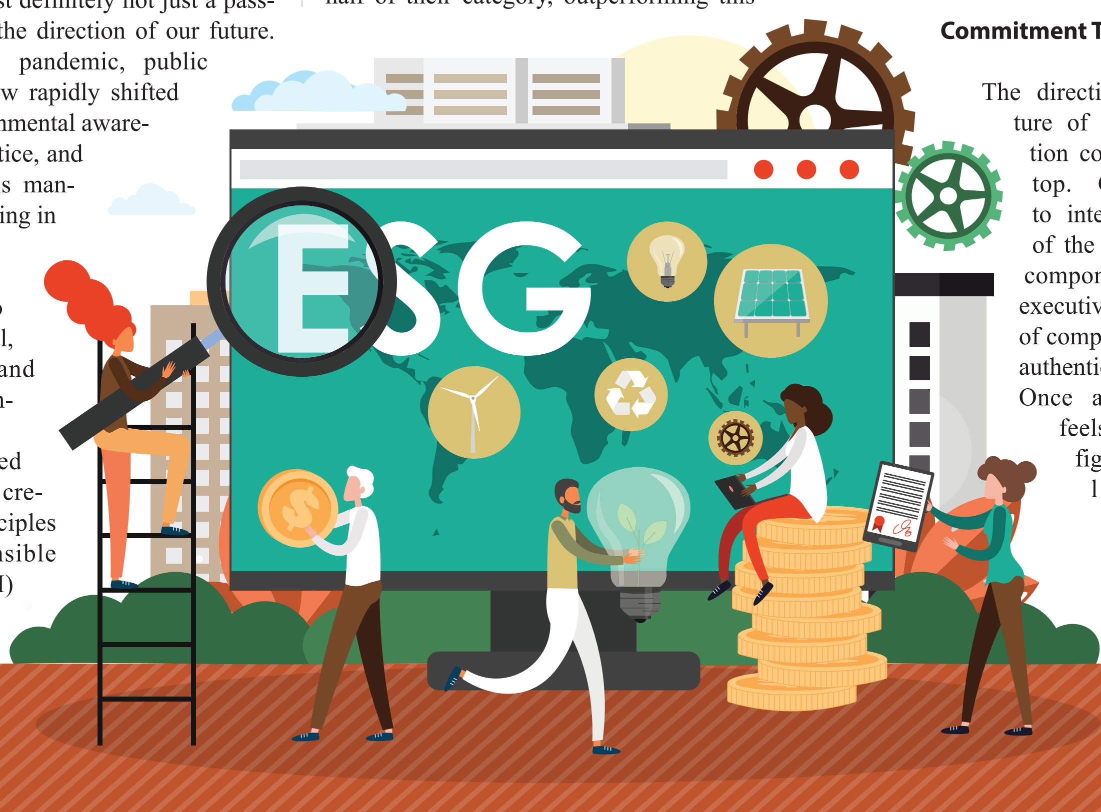
Research shows that the investment in funds that promote social good and environmental protection more than doubled year-over-year in 2020. Many funds now employ ESG principles that promote racial and gender diversity while avoiding energy firms that are solely reliant on fossil fuels. According to Morningstar, ESG funds grew in 2020 for the fifth straight year by securing $51.1 billion of net new money from investors. The trend continued in 2021. In 2022, six funds covered by Morningstar analysts ranked in the top half of their category, outperforming this year in a tough market.

The strong 2022 performance for ESG funds is not diminishing in the future with more money, grants, and pressure directed towards funds prioritizing ESG. New AuM (assets under management) records will be set because Millennials and Gen Z are more likely to make 'green' decisions than previous generations. Understanding that the smart money is going towards climate improvements and companies that exhibit more diversity, equity, and inclusion means that investments in ESG have a significant tailwind.

ESG is the right thing to do and makes good business sense over the long run. Companies with poor governance and questionable integrity are not sustainable. If a company treats its employees poorly, it will not be able to attract and retain the best talent. If a company does not have proper diversity, equity, and inclusion procedures in place, then it becomes more vulnerable to groupthink. It is not surprising that companies that truly integrate ESG outperform those that do not. The crypto disaster FTX is a case study of poor governance. FTX was a colossal failure, despite having bountiful assets because it ignored proper controls.

Commitment To Integrity

The direction and culture of an organization come from the top. Commitment to integrity is one of the most critical components in the executive leadership of companies that are authentic about ESG. Once an employee feels as though figures in their leadership may not be truthful about one thing, it



takes away from their credibility. Talented and virtuous workers will leave and those that tolerate mistruths will stay.

So, what can you do? Simply, every organization should have an ESG policy. Institutional investors may consider joining the Canadian Coalition for Good Governance. For hedge funds, the ESG policy is a living document similar to the policy and procedures or compliance manual. Although a hedge fund's trading strategy may not directly involve ESG, its ESG policy should cover items such as hiring policies, recruiting, compensation, and culture. The culture should allow for inclusion, equity, and diversity. Putting thought into the ESG policy will resonate with many institutional investors. This is especially true if the hedge fund manager can demonstrate strict adherence by the organization.

Before trying to change the world, apply ESG to your own organization. Be authentic! This is true for both investors and hedge funds. To what extent do you manage your environmental footprint? To what extent are you transparent in your contributions to a country? Does your board of directors have BIPOC (black, Indigenous, and people of colour) representation? What percentage of the executive committee is female? From an organizational perspective, what are you doing to ensure that your recruitment is not too narrow? This all has an impact on your license to operate in the minds of the stakeholders around you.

Immediate Ecosystem

Next, apply ESG to your immediate ecosystem – the service providers that you hire. It is important to hold these firms accountable. If your auditor has been fined by regulators for significant infractions, it probably does not warrant outright dismissal, but it should not be given a free pass either. Actions must be clear and consistent: the wrong message is delivered if a hedge fund has an ESG trading strategy, but uses service providers that are misbehaving. A firm's ecosystem – who they hire, who their client is, and who they surround themselves with – are all indicative of what that firm stands by and promotes within its own company culture.

Additionally, proactively reporting your ESG initiatives externally demonstrates to shareholders that the company is investing in this earnestly.

However, the rise in attention towards ESG can also lead to the rise in greenwashing. Greenwashing is when a firm makes claims about its sustainability practices, goals, and/or considerations, but does not follow through and instead participates in unsustainable practices. Hypocrisy and inauthentic dedication towards ESG undermine brand image. During the pandemic, some multi-billion dollar financial firms which were UN PRI signatories received money from taxpayers via the Canada Emergency Wage Subsidy and then proceeded to give their executives lucrative million-dollar bonuses. The hypocrisy was called out by some newspapers.

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Taking methodical and achievable steps towards achieving more equitable and sustainable practices and decisions within a company can benefit the firm, its employees, and the planet far longer than short-term grandiose and glamorous initiatives that the firm has no intent of keeping up. A culture of greenwashing gets in the way of legitimate ecological initiatives.

One challenge is although many groups have tackled the problem of assigning ESG ratings to companies, there is no consensus regarding the best approach. Unfortunately, the process is fragmented and there are many gaps in the data quality. For example, sone hedge funds that trade in the ESG space have either selected the service provider that best fits their needs or have developed their own ESG scoring system. In some cases, these funds utilize the service provider's ratings as an input for a hybrid approach.

The environment has complex issues that are difficult to model. It is important to understand that the intricate, interconnected nature of the global ecosystem can lead to unintended consequences that are not immediately realized. In February 2021, the state of Texas suffered a major power crisis caused by poor planning exacerbated by three severe winter storms. It was a massive electricity generation failure that resulted in a shortage of the basic necessities of heat, food, and water. Climate change requires increased standards including the stress testing of vital infrastructure. There is no exaggeration in stating that these issues are central to life.

Less Aware

In general, the finance community is less aware of the unintended consequences than the scientific community. There may be first order or second order policy effects that are difficult to predict. Consistent, meaningful interaction with the scientific community should improve the risk models and reduce the problem of unintended consequences.

ESG is here to stay because it serves to maintain the health of our planet and its societies. Although it is complex, the problems provide opportunity and the best groups will innovate to capitalize.

ESG efforts are not always smooth sailing, bumps along the way are to be expected. Some mistakes will be made and solutions will take time. However, social license can be considered corporate 'oxygen' and companies cannot idly sit by and hope things will work out. **BPM**

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