

ESG and Capital Allocation

Published on: 1 October, 2021 | Author: Investment Team

Since 1900, population density has risen from 15 people per square kilometre, to 30 in 1960 and 60 in 2020. Compared to our Victorian ancestors, now each of us has only $\frac{1}{4}$ of the land available to support our needs. Biologically, we all need to eat, breathe, and excrete.

It is estimated that out of a total surface area of 510 million km^2 , $\frac{1}{8}$ of the world's surface is suitable for humans to live on. In another words, 63.75 million km^2 must support and sustain the current global population of a little under 8 billion people.

This is why Nobel laureate, Paul Krugman, Professor of Economics and International Affairs Emeritus at Princeton University noted that in the long run, “productivity not only matters, but it is also the only thing that matters.”

Investors are only too aware of this, which is why in part, the technology sector in recent years has far outpaced other areas of the market.

Ironically, despite all the investment, it is very hard to find evidence of the expected productivity gains in the broad economic data. Indeed, it has been suggested that one reason why Xi Jinping has stopped children spending more than three hours per week playing games is precisely because (like most middle-aged parents) he sees playing games and social media as unproductive and a poor use of technology.

It may be that technology is too narrow a label to look for productivity improvement and the firms we should look for are those who can demonstrate rapid adaptation across the broad swathe of the economy. There are two sides to this: one is innovation and technology and the other is the ESG movement focussing on environmental sustainability.

The Covid pandemic and ongoing logistics problems, petrol deliveries for example, have highlighted our capacity to develop entirely new industries (who knew what a Zoom conference was 18 months ago) but also our continuing dependence on “old industry,” hydrocarbons for fuel.

Technology has transformed the distribution of ideas, music, and entertainment but not yet, transport, agriculture, and energy. In the UK, the NHS and healthcare takes up an increasing amount of the budget merely to stand still, yet extraordinary medical technical innovation has proved unable to deal with the relentless expansion in demand as we all age. This will ultimately only be changed through technological innovation in medicine.

Productivity gains in agricultural production are essential to life, but the ethical apparatus surrounding genetic engineering to develop drought resistance and tolerance to elevated salinity – a feature of areas with intensive water use – is a limiting factor.

In the energy sector, it is the chemistry not the physics that counts. Battery technology, weight for weight, cannot replicate the energy density of petrol. Nonetheless, in the floating greenhouse in which we all live, the proportion of heat absorbing gases in the atmosphere must decline. We know companies are researching and innovating in batteries, carbon-capture and new fuels. There is no shortage of opportunity.

Environmental, Social and Governance (ESG) is the other side of these developments. They are either being adopted by corporations or, as in the cases of Exxon and Shell recently, being forced upon them by activist shareholders.

Shareholders want their boards to take these issues seriously. We believe that those that do will develop an important competitive advantage over those that drag their heels.

This extends to finance. There is a growing market in “green bonds” where firms raise money that is firmly hypothecated to sustainable investment and socially aware programs. In due course we expect this to affect pricing i.e. green projects will benefit from lower-cost funding.

This is all positive in the longer term, however as investors we must remember that allocation of capital and well thought through investment ultimately drives future returns. History is littered with investments that were made for the greater good but did not result in positive returns. In many cases investors lost their money. It is for this reason that we are focussed on investing in those companies that have a long track record of adapting to the environment within which they operate rather than new businesses that may or may not succeed. We will be providing more detail on the positioning of our strategies in this regard before the end of the year.

Doing more with less really is the key to superior productivity and profitability. As the statistics at the top of the page illustrate, the world truly is getting smaller.

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