Insights, Tacit Thought | Weekly Investment Insights

What is Sustainability, Really?

Published on: 29 May, 2020 **|** Author: Investment Team

As the pandemic and the secondary effects of the lockdowns have unfolded, global equity markets have declined. Some ESG (Environmental Social Governance) funds have actually had very muted declines, relatively speaking. This is mainly because they have avoided most of the hardest hit sectors of the economy because of their environmental impact – the energy sector, automobiles, and travel/leisure.

Most ESG funds have a bias towards technology and healthcare companies. These companies are not capital intensive and therefore have a minimal environmental footprint. These companies also have very few employees relative to their revenues and profits. Herein lies the problem with ESG scores, more specifically the S (Social) in ESG. Trying to quantitatively optimise for something as complex as social impact, using a single score, can create unintended consequences.

ESG investing, as it stands, suffers from the McNamara fallacy. This fallacy involves making decisions solely based on quantitative observations. The problem? You cannot measure what you cannot clearly see and just because something cannot be easily measured does not mean it is not important. The fallacy is named after Robert McNamara who was the US Secretary of Defence during the mid-part of the Vietnam war. In simple terms, McNamara's models were focused on optimising body count i.e. a low US body count and a high enemy body count will eventually lead to military success. Both of these were easy to measure; therefore its importance was exaggerated. What was almost impossible to measure – the will of the rural Vietnamese to engage in guerrilla warfare, was ignored precisely because it could not be easily measured and arguably cost the US the war.

Most investors in ESG funds are trying to maximise returns while simultaneously minimising the environmental and societal impact of their investments. The most defining feature of companies that have high ESG scores is not the fact that they are more profitable or sport higher returns on equity. The most defining feature, according to research carried out by Vincent Deluard, is that they hire fewer humans.

To quote Deluard:

> *"ESG's bias against humans is probably unconscious, but it is a feature, rather than a bug. Companies with no employees do not have strikes or problems with their unions. There is no gender pay gap when production is completed by robots and algorithms. Biotech labs where a handful of PhDs strive to find the next blockbuster molecule have no carbon footprint. Financial networks which enjoy a natural monopoly in processing payments can have the luxury of ticking all the boxes of the corporate governance checklist."*

As capital flows towards investments with higher ESG scores, the unintended societal consequences of capital flowing out of well-paid but capital-intensive jobs is not considered as a negative, since it cannot be easily measured – the McNamara fallacy.

Wealth inequality will probably accelerate as the trend towards automation continues. Also, it becomes easier for companies to game statistics like gender and racial pay inequality. As jobs become increasingly automated, gender and racial inequality will appear to disappear. Pay inequality drops to zero if algorithms and robots replace humans. Profit margins also go up since algorithms and robots cannot demand raises pegged to inflation. However, the social cost will be real, painful, and difficult to measure. And it may go ignored for a long time precisely because it is difficult to measure.

Investing in companies that consider the environmental and societal impact of their operations is a good idea. However, like most good ideas taken to their logical extreme, negative unintended consequences often arise such as increasing inequality and punishing entire continents whose economies are dependent on capital intensive industries.