Why ESG investing isn't a fad

The days of the traditional, single-view valuation of companies are long gone and ESG (environmental, social and governance) investing is not a fad. This class of investments, known as "sustainable investing", is an umbrella term for investments that strive for positive returns and long-term impact on society, the environment and the overall performance of a business.

ESG is redefining the investment industry and shaping how companies are being valued now and into the future. So says Francis Marais, Head of Research at Glacier by Sanlam, as he unpacks some of the key issues for investors.

Beyond the numbers

If we accept that companies operate within society, we also accept that society can revoke the licence that the company needs to operate and flourish. ESG criteria are a set of standards for a company's operations that socially and environmentally conscious investors use to screen potential investments.

Environmental criteria consider how a company performs as a custodian of nature. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. The 'governance' part of ESG deals with a company's leadership, executive salaries, audits, internal controls, and shareholder rights.[1]

Youth with a conscience

ESG is of concern to all investors (or should be), but if you are between the ages of 30 and 40 years, ESG is probably of particular importance to you. Francis notes that in Europe, robust investor activism – the active pursuit by investors for a focus on ESG – has existed for a lot longer then locally. In South Africa, there has been the mindset that ESG investing detracts from returns. However, this is changing fast, says Francis. Young investors are far more conscious of ESG criteria and are mindful of where their money is being spent or being invested, so are asking the tough questions and often making demands for change.

Companies that (holistically) add value, have value

There is a move from the simplistic, traditional view of how we value companies to a more holistic view of all of a company's operations that are taken into account in the valuation process. A company may be doing well financially but may be polluting the environment. Society decides whether that company will continue to operate – it's as simple as that. Pressure to change its practices by not buying its products, is one way that society will revoke the licence. Exerting taxes and fines is another way, which would mean wasted resources for the company. That company's revenue or expenses would be impacted which would in turn affect how it is valued as an investment. The same applies to companies that use exploitative labour practices, or those embroiled in dubious financial transactions which are at odds with good governance protocols. These factors – the richer picture if you will – are opening analysts' eyes to the risks that previously may have been blind spots. So, financial figures are fast becoming just one dimension in the valuation process.

ESG is central to pricing

How do investment managers integrate ESG? That is the multi-billion-dollar question. Francis points out that launching a bunch of ESG funds is not the answer. All equity funds should be incorporating the ESG data set. The reason is quite simple: if all information is not incorporated, then there is slim likelihood that the pricing of that company is efficient. The only way to get to the efficient intrinsic value of a company is by looking at all of its material information and incorporating the data in decision-making. A continued focus on a single data set will lead to continually wrong valuations.

Change is coming, says Francis, slowly but surely. The investment industry has been slow to change as it has operated on a set of dogmatic beliefs that have impeded the inevitable move to ESG thinking.

The tough questions

Even hard-nosed capitalists would agree that humanity is not doing well at present (and that's not even touching on nature which has all but been destroyed by us). We need to ask the tough questions. We need to view and value companies using many lenses, not just the traditional financial ones. We can learn from Europe, where regulators, institutional investors, pension funds and retail investors all continue to demand change. They continue to ask the tough questions about investments in companies that manufacture weapons or pollute the oceans. We must change the narrative that ESG investing means unfavourable investment returns. It doesn't. In fact, it means improved risk-adjusted returns, and that's just good business all-round.

[1] Investopedia.com

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