VULCAN ESG

ESG - Environmental, Social and Governance

History

In September of 1970, the economist Milton Friedman wrote an essay entitled “The Social Responsibility of Business Is to Increase Its Profits.” He argues that corporate managers “should conduct the business in accordance with shareholder’s desires, which generally will be to make as much money as possible while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom.” Ethical questions are then left to individuals and government, the sole social responsibility of the firm is to maximize profits.

Now armed with the MBA buzzword ‘stakeholders’, critics argue for boards to prioritize them (who decides who ‘them’ are?) in their decisions. Interestingly, while agreeing with Friedman’s underlying premise, Harvard’s Oliver Hart and Chicago’s Luigi Gonzales eagerly reject the view that *shareholders* care only about money. If corporate managers maximize profits, shareholders remain free and even emboldened to spend as environmentally or socially as they choose. Objectives may be different, Friedman concedes, but these objectives are better left to shareholders to pursue. In other words, shareholders maximize utility rather than income. Friedman never asserts that social activity is pointless. Just that it is an independent activity from profit-making.

On December 2, 1984, an accident occurred at the Union Carbide pesticide plant in Bhopal, India. Some 600,000 residents were exposed to a release of 30 tons of methyl isocyanate, among other rather nasty gases. The death toll ranged in size from 3,800 to as many as 16,000. Thirty years later, many of those exposed to the gases have given birth to physically and mentally disabled children. The Government of India sought $3.3 billion in damages, but Union Carbide settled for $470 million in 1988.

On April 20, 2010, methane gas leaked up the marine riser of the oil platform Deepwater Horizon in the Gulf of Mexico, ignited, exploded, and engulfed the entire platform where it killed 11 workers. The platform then sank on April 22nd. The total amount of oil spilled was 4.9 million barrels or 210 million gallons. BP paid out over $20 billion in damages, the largest corporate settlement ever.

The existing movement, known as Socially Responsible Investing (SRI), now morphed into something larger. What was then an asterisk – * “we don’t buy tobacco or defense stocks” - congealed into a movement which had the imprimatur of a growing number of legal and regulatory agencies.

Our Three Views of ESG: Consensus, Purist and Absolutist

Consensus

Investing

The investing sales pitch for ESG is that companies that improve their social 'goodness' not only improve their profitability and become more valuable over time, but that they advance society's best interest at the same time.

One of the bigger tailwinds came from The Business Roundtable essentially renouncing Friedman with their new proclamation.

In 2019 they modernized its principles on the role of a corporation. Since 1977 they have stated corporations exist primarily to serve their shareholders.

They now commit to:

- *Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.*
- *Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.*
- *Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.*
- *Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.*

Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities, and our country.

The markets listened. Money flowed into ESG funds and seemed for some companies to be a tipping point about the added benefit of being socially conscious. Or at least appearing to be so. Do these money inflows affect valuations if they are already priced in?

I taught my finance students at ASU the fundamentals of valuation. To increase valuation, at least one of the following four variables must change: revenue growth, operating profit margins, reinvestment efficiency or risk. Risk appears to the common thread to ESG investing. Risk is where cost of funding/capital and failure live. And since, as public bodies, you only invest in corporate debt, not the equity, let's briefly touch on that.

A bond is essentially a loan. So, by loaning a 'good' company your funds, in aggregate their cost of capital would decline. This not only increases the valuation of the company but lowers the return to you the investor. Conversely, by starving a company, or sector, of capital you not only drive up their cost of capital but also deny yourselves the increased returns provided by decreased valuations or increased risks. There are costs to being 'good.'

The Financial Times, via Grant's, had a sweeping summation last August.

The big four accounting firms are moving headlong into the realm of environmental, social and governance-based investment, the Financial Times relays today. The bourgeoning movement presents a dueling opportunity set, the FT notes, including "an expansion of what companies must account for," as well as the opportunity to "rebrand a scandal-plagued profession as experts on climate change, diversity and winning consumers' trust." Back in June, industry mainstay PwC announced a five-year, $12 billion investment plan centered on ESG initiatives, while peer Deloitte earlier this month rolled out a "climate learning plan" for its own staff.

Commercial factors loom large in that green migration. "One of the challenges the profession has faced. . . is that the audit or financial statements were viewed by some as a compliance function," a former senior partner at PwC told the FT. "If [companies] look at something as a compliance or commodity purchase, they grind the price. If they look at it as something that adds value, they're willing to pay the appropriate price for the value that the service provider provides."

Investors have proven more than willing to pay up for the sustainability wrapper. ESG-focused equity funds charged investors 20 basis points on average as of year-end 2020, per data from FactSet. That's comfortably above the 14 basis point fees generated by conventional stock funds. Explosive growth puts that premium into further context: Some $17 trillion of capital tracked ESG-related strategies as of year-end by the lights of the Forum for Sustainable and Responsible Investment, up 42% from 2018 and representing one-third of total U.S. assets under management.

Considering that backdrop, it is no surprise that companies looking to finance themselves would seek the ESG imprimatur, whether warranted or not. In an Aug. 20 blog posted on Medium,

Tariq Fancy, former chief investment officer for sustainable investing at BlackRock, termed the ESG craze "a dangerous placebo that harms the public interest." Fancy went on to cite the $1 trillion market for "green bonds," or debt deals earmarked for specific ESG-friendly initiatives, as one area rife with bunkum. "Most companies have a few qualifying green initiatives that they can raise green bonds to specifically fund, while not increasing or altering their overall plans. *And nothing stops them from pursuing decidedly non-green activities with their other sources of funding," the BlackRock alum reasons.*

Then, too, the financial industry faces a similar reckoning, as participants market themselves as members of the ESG vanguard while vying for assets. Last Wednesday, The Wall Street Journal reported that federal prosecutors and the Securities and Exchange Commission have opened investigations into Deutsche Bank's DWS asset management division for alleged greenwashing, or falsely burnishing its environmental bona fides. Germany's Federal Financial Supervisory Authority is conducting a similar probe, Bloomberg relays. While DWS told investors in its March annual report that it had conducted a self-described "ESG integration process" covering more than half of its $1 trillion in assets under management, an internal audit a month earlier determined that "only a small fraction" of its AUM were ESG compliant. "As we are already quite late to the game, we need to set our ambition now and start the transformational process," ESG product head Oliver Plein entreats his colleagues in an email accompanying that audit.

"Posturing with big statements on climate action and inclusion without the goods to back it up is really quite harmful as it prevents money and action from flowing to the right place," whistleblower Desiree Fixler told the Journal. Formerly the chief sustainability officer at DWS, Fixler asserts that she objected to the firm's claim that they "placed ESG at the heart of everything that we do" and was fired a day after the firm released its annual report.

Yet those greenwashing allegations may be hard to prove, as Bloomberg analyst Sarah Jane Mahmud wrote on Thursday that "fund categorization remains subjective." Indeed, the primary ESG rating firms employ widely disparate criteria, with MSCI utilizing 37 different metrics to evaluate firms ESG compliance, while Sustainalytics uses 155 categories and Refinitiv 178. Those agencies also differ on whether to incorporate the industry in which a firm operates into its evaluation.

One thing we can all agree on: ESG makes for great talking points. "We believe the world has a unique opportunity of rapprochement and coming together to tackle the challenges not only facing us but the entire humanity," Abdul Qahar Balkhi, a member of the Taliban's Cultural Commission, told Newsweek last Tuesday. "And these challenges ranging from world security and climate change need the collective efforts of all."

Innovation

From a piece I later quote: “In the long run, innovation and cheap capital will determine who wins the clean energy revolution.”

A paper was released last year which may not have raised enough eyebrows. Titled “The ESG-Innovation Disconnect: Evidence from Green Patenting”, authors Cohen from Harvard, Gurun of the University of Texas at Dallas and Nguyen of De Paul take 42 pages to explain. They summarize……

We find consistent and robust markers that the quantity and quality of green patenting is higher for energy firms. Paradoxically, these firms are precisely those to which capital is often restricted by mandates and campaigns whose directive is to solve the important problems linked to green innovation. Our analysis thus suggests there is, perhaps surprisingly, a negative relationship between the generators of innovation that can help us confront environmental challenges and where capital is being directed. That said, there is still work to be done as to whether capital allocation indeed follows the ESG scores, and to what extent this ESG score-motivated investment can calibrated to achieve better capital allocation by the investors.

Stepping back, we believe investigation of these issues will provide critical insight into the shifting landscape of innovation, allowing us to capture and assess the full welfare impact of ESG capital on the economy. Moreover, our findings raise important questions as to whether the current exclusions of many ESG-focused policies – along with the increasing incidence of explicit divestiture campaigns – are optimal, or whether reward-based incentives would lead to more efficient innovation outcomes.

Central banks

If you thought central banks were tasked with keeping prices stable, optimizing employment, and keeping the banking system sound, think again. They have not wavered in their commitment to ‘climate-related risks.’ Fed governor Lael Brainard is growing impatient. She stated last fall:

“Ultimately, I anticipate it will be helpful to provide supervisory guidance for large banking institutions in their efforts to appropriately measure, monitor and manage material climate-related risks,”

“Climate change could have profound consequences for the level, trend growth and variability of economic activity over time,” she said. And the coronavirus pandemic “is a stark reminder that extreme events can materialize with little warning and trigger severe losses and market disruptions.”

Spilling over into the world of valuation and insurance, she said natural disasters and government policy actions to address climate change "could quickly alter perceptions of future risk or reveal new information about the value of assets."

Central banks also know no borders. Since climate change is global, so too must be the attempts to address it.

In the U.K., Treasury chief Rishi Sunak this year changed the remit of the Bank of England's interest-rate-setting committee to include "strong, sustainable and balanced growth that is also environmentally sustainable" as well as maintaining price stability.

The Bank of England has added climate risks such as rising temperatures and sea levels to its bank stress tests. In the past, stress tests mostly measured whether banks could withstand hypothetical economic scenarios such as big recessions or financial crises.

The ECB will now scour banks' trading books for "climate-change risk', whatever that is. Tyler Durden adds, "because in the continent, cowardly politicians - unwilling to take on the career risk of legislating the unpopular change they want - **instead want banks to become a key plank in the fight against climate change by steering capital away from polluters.**"

Insurance

Just after the Deepwater Horizon disaster, in 2010, the Treasury Department's Federal Insurance Office ("FIO") issued guidance to public companies on climate change-related disclosure obligations.

Moving on from mere disclosure, Marsh & McLennan now works to provide better terms in insurance based on ESG actions and scores. Highlights include:

Marsh and McLellan's brokerage unit has teamed with international law firms and four major insurance carriers to recognize corporate clients for strong efforts in the increasingly high-profile areas, including such things as climate-change disclosures and representations.

The law firms, with expertise in ESG litigation and regulation, will review, evaluate and in some instances bolster the ESG programs and policies of Marsh's clients. Marsh's brokers will seek coverage for these clients from the four participating carriers, with the goal of obtaining enhanced terms and conditions for those with superior ESG practices.

As companies invest in ESG programs, "it is right that those companies that are truly making investments to improve their ESG standing be recognized as a better risk by underwriters," said Maureen Gorman, a managing director in Marsh's U.S. financial and professional-lines division.

In April, insurance ratings firm A.M. Best Co. cited a surge in lawsuits and the size of jury awards and settlements. Best said corporations could sustain reputational damage over their failure to

disclose climate-change risks, or face lawsuits brought by shareholders alleging either corporate inaction to address diversity issues or the failure of boards to act on diversity goals.

Around the same time, Bates Group, a compliance firm, reported on the same subject:

Referring to the 2010 guidance, the SEC added that disclosure must include the direct and indirect impact that climate-related legislation, regulation, international treaty, or business trends may have on the company, as well as any physical impact the company may have suffered because of a climate event or change. Those areas were the categories of concern contained in an "illustrative letter" that the SEC issued. By publishing it, the SEC revealed its expectations for what firms should provide in anticipation of the agency's intent to "selectively review" company filings.

Underlying another request for information, FIO cites extreme weather volatility, corresponding economic losses, changing socio-economic concerns, insurer's responses to these challenges, and a market that is increasingly unable to provide affordable and available property coverage. FIO also notes that "insurers could be vulnerable to potential decreases in asset values arising from the transition towards a low-carbon economy."

The new SEC guidance reinforces standard existing disclosure requirements (on material information, operations results, and other risks), and pushes climate-related guidance to the top of the compliance priority list. More and more, the SEC has expressed concern for companies using social responsibility and in particular, climate-related concern as an embellishment to corporate marketing efforts. The illustrative letter suggests that the agency will be looking closely at those firms for adequate disclosures that will not mislead investors. Compliance professionals—take note.

The extent of the FIO request for climate-related information on the insurance sector is breathtaking. It is as much a policy pronouncement on the possible necessity to restructure the entire insurance industry as it is a request for information on how best to do it.

Geopolitics

"On Wednesday, January 5, 2021, Kazakh President Kassym-Jomart Tokayev accepted the resignation of the government after violent protests erupted due to a natural gas price increase in the country, Reuters reports. Police had deployed tear gas and stun grenades to quell unrest late Tuesday, and on Wednesday morning Tokayev declared a state of emergency in the southeastern city of Almaty and the western region of Mangystau, imposing a curfew and movement restrictions, according to AFP and Reuters. Protests began on Sunday after price caps were lifted on liquefied petroleum gas on Saturday, causing prices to more than double, Radio Free Europe reports."

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ESG

At the heart of ESG is de-carbonization. The United Nations has decided the use of carbon-based fuels will lead to irreparable harm to our planet. And since the global economy – and life - runs on energy, mostly carbon energy, that presents a problem. This section deals not with the chemistry of de-carbonization but the geopolitical impacts of this energy transition.

Jason Bordoff of Columbia and Meghan O'Sullivan write powerfully in the latest Foreign Affairs, title "Green Upheaval."

Tall of a smooth transition to clean energy is fanciful: there is no way the world can avoid major upheavals as it remakes the entire energy system, which is the lifeblood of the global economy and underpins the geopolitical order.

Perils that will arrive in the next few decades, as the new geopolitics of clean energy combines with the old geopolitics of oil and gas

If people come to believe that ambitious plans to tackle climate change endanger energy reliability or affordability or the security of energy supplies, the transition will slow.

Oil producers such as the Gulf states—which have very cheap, low-carbon oil, are less dependent on the financial institutions now shying away from oil, and will face little pressure to limit production

In the long run, innovation and cheap capital will determine who wins the clean energy revolution. Countries with both those attributes will dominate in at least four ways.

One source of dominance—the power to set standards for clean energy.

Standard setting will be particularly important when it comes to nuclear energy. According to the IEA, global nuclear energy generation will need to double between now and 2050 for the world to achieve net-zero emissions. As of 2018, of the 72 nuclear reactors planned or under construction outside Russia's borders, more than 50 percent were being built by Russian companies and around 20 percent by Chinese ones; fewer than two percent were being built by U.S. companies.

A second source of dominance in a clean energy world will be control of the supply chain for minerals such as cobalt, copper, lithium, nickel, and rare earths, which are critical to various clean energy technologies, including wind turbines and electric vehicles.

China's control over the inputs for many clean energy technologies is not limited to its mining prowess; it has an even more dominant role in the processing and refining of critical minerals. At least for the next decade, these realities will give China real and perceived economic and geopolitical power.

The third element of clean energy dominance will be the ability to cheaply manufacture components for new technologies

Such turmoil could stall the energy transition if it encouraged consumers to turn back to gasoline vehicles or cancel plans to install rooftop solar panels.

A final way in which a country could become a clean energy superpower is through the production and export of low-carbon fuels. These fuels—especially hydrogen and ammonia—will be critical to the transition to a net-zero world given their potential role in decarbonizing hard-to-electrify sectors, such as steel production; fueling trucks, ships, and other heavy vehicles; and balancing grids supplied primarily by renewable sources of energy that can experience intermittent disruptions.

The transition to clean energy will exacerbate already deep inequalities and potentially produce a political backlash.

How to Lower the risks

The clean energy transition demands a complete transformation of the global economy and will require roughly $100 trillion in additional capital spending over the next three decades. There is little reason to expect that such a radical overhaul can be completed in a coordinated, well-managed, and smooth way.

First, policymakers need to expand their toolkits to increase energy security and reliability and prepare for inevitable volatility. For starters, it would be shortsighted to scrap an existing zero-carbon energy source that can operate consistently—namely nuclear power.

Policymakers should also maintain maximum flexibility on energy sources even as they phase out “brown” energy. Given the uncertainty about future needs and demands, policymakers should be prepared to keep some legacy fossil fuel assets in reserve in case they are needed for brief periods during the transition when there is a disconnect between supply and demand.

Another way governments can boost energy security is by reducing supply chain risks—but not in a way that would encourage protectionism. Officials shouldn’t chase the chimera of independence but instead try to build flexibility in a diversified and interconnected system.

Purists

What I call the Milton Friedman, or University of Chicago, School is much like the Hoover Institute at Stanford. More wish to see it leave than remain. But even inside the Purist camp, there seems to be several strands, the moralists, the pragmatist and the legalists.

Moralists, like Friedman, posit that corporations have a *moral* duty to maximize shareholder value and have a *moral* duty to avoid doing anything which may work against that mission. Shareholders and government have the freedom, obligation and even duty to support a charitable and even democratic process addressing externalities others may and should find problematic.

Pragmatists care even less about morals than do libertarians and will only look at returns. They may care even less about externalities. Do investors in ESG corporate bonds face lower returns? Whether only clad in the veneer of a high ESG score (known as greenwashing) or affecting change, only returns matter. Authors Chiesa, McEwen and Barau wrote in the Spring 2021 issue of The Journal of Impact and ESG Investing a piece entitled “Does a Company’s Environmental Performance Influence Its Price of Debt Capital?” They conclude it does. A Larry Swedroe tidily summarizes in a piece from last fall:

Economic theory and the evidence show that high ESG scores lead to lower corporate bond spreads. This is consistent with research showing that higher ESG scores also lead to higher equity valuations. Thus, a focus on sustainable investment principles leads to lower costs of capital, providing companies with a competitive advantage. It also provides companies with the incentive to improve their ESG scores. In other words, through their focus on sustainable investment principles, investors are causing companies to change behavior in a positive manner.

The legalist holds that ESG investing, as fashionable as it may be, is advanced through undemocratic means. He goes beyond (or beneath) Friedman’s moralism and looks at ESG solely through a legal lens. This summarizes a piece entitle “ESG Investing May be in Vogue, but Beware.”

the incorporation of non-economic factors in the consideration of investment decisions runs counter to longstanding statutory and jurisprudential notions of fiduciary duty. Section 404 of the Employment Retirement Income and Security Act of 1974 (ERISA) establishes the duties of plan fiduciaries to act in the sole interest of participants and beneficiaries to maximize the risk-adjusted return of plan assets. Incorporating non-pecuniary considerations in the investment selection process runs counter to this obligation and highlights one of the flaws in large institutional investors’ advocacy for the application of ESG criteria. Such “institutional investors” should more properly be termed investment “advisers” or “managers,” since they make investments on behalf of plan or fund beneficiaries, not for their own account.

ESG

Notwithstanding its high-minded intentions, ESG is subjective, logically inconsistent, and encourages rentier behavior. It is also undemocratic, elitist, fiduciarily unsound, value degrading, and lacks accountability. Other than that, what's not to like?

Not flawed points.

Absolutists

The Revolution Will Not Be Privatized. So says Diane Coyle from the University of Cambridge in the latest edition of Foreign Affairs, upon which we leaned earlier. Snowballs rolled larger in size a year earlier, also in Foreign Affairs in 2020, when Klaus Schwab said that companies must actively take "steps to meet social and environmental goals" or risk having "employees, clients, and voters…force change on them from the outside."

Ms. Coyle adds by subtracting the corporation. *"Despite purportedly having good intentions, many corporations are not genuinely interested in bettering the world, and some use ESG metrics or other sustainability measures mainly to launder their reputations. Fixing some of the world's most vexing problems will require that businesses dramatically alter their own practices, and it makes little sense to entrust systemic reform to the very institutions that themselves require change."*

You know where this is headed. *"Instead"*, she writes, *"action must come from elsewhere: namely, governments."*

She does admit to serious headwinds, namely that governments have lousy reputations for getting anything done. Or, done right, I should add.

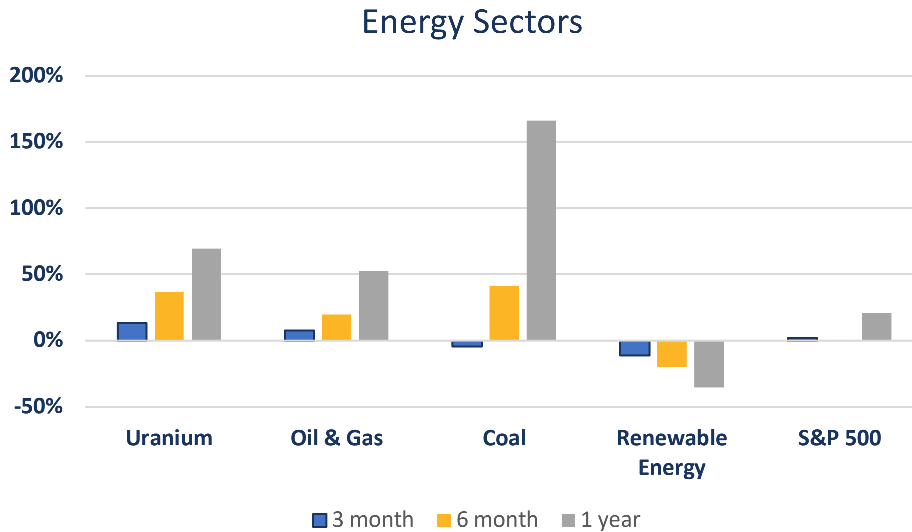
"The problem is that despite all the criticisms of the business world, many people believe that companies are more effective than governments at achieving desired changes. According to the latest annual Edelman Trust Barometer, survey respondents around the world had more faith in businesses than in governments or politicians. Indeed, according to the 2021 findings, the business world is the only institution now seen as both ethical and competent despite the hugely increased presence of the state in economic life since the start of the pandemic."

Without irony, Friedman, of all people, makes an appearance. But not for long and ultimately with little accolade. *"But even Friedman understood that it would be dangerous to have businesses become too involved in addressing public issues. Part of his argument against corporate social responsibility was that it was undemocratic. Corporate money spent in pursuit of anything other than profit, he argued, was tantamount to taxing shareholders (or customers and employees), and taxing and spending are properly the business of government—not the business of businesses. "Here the businessman—self-selected or appointed directly or indirectly by stockholders—is to be simultaneously legislator, executive and jurist," Friedman wrote. "He is to decide whom to tax by how much and for what purpose, and he is to spend the proceeds.""*

I ask, if neither shareholders nor corporations are entitled or even obligated to spend profits to advance societal needs, are they even shareholders at all?

Saying the quiet part out loud, she finishes off by admitting *“Governments will need to force companies to invest in new technologies and ways of operating and to pay higher energy costs during the transition. In order to restore healthy markets for customers and workers, states will need to cut into the revenues of dominant businesses.”*

Reality Always Wins



VULCAN
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Conclusions and Recommendations

Vulcan's Conclusions and Recommendations

ESG has now become the framework within which we will be forced to live, borrow, and invest. It still fumbles around, seemingly in the dark, between countries, central banks, and regulatory agencies. Data and metrics are far from being standardized. What we know for certain is ESG is and will be the greatest re-allocation, mis-allocation and mal-allocation of capital since QE and MMT. How do we proceed?

- Learn what ESG is and, perhaps, more importantly, what it isn't.
- Ask yourselves, not your neighbors. Neighbors have differing taxpayer sentiment, council style, risk and reward tolerances and cultural and ideological imperatives than you.
- Find synchronicity across the balance sheet – does our borrowing motif match our investing motif?
- Find synchronicity across the building. Remember, the same scrutiny which punctuates your investing will punctuate your operations. For example, are you buying more EV vehicles while owning Exxon Mobil bonds?
- Find synchronicity across the city. Passionate citizen groups can be loud. Are they congruous with existing practices? Do they have outsized influence compared to others?

Quite simply, your ESG profile must capture the sentiments and cultures which reflect the nature of your community. And this profile must be developed with thought and reason. That is why Vulcan uses multi-criteria decision analysis, (MCDA) and analytic hierarchy process (AHP) to develop the posture which reflects your values and fulfills compliance demands.

Vulcan ESG is the premier firm dedicated to ESG Risk Solutions and Strategies.