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INSURANCE AND FINANCIAL PRACTITIONERS ASSOCIATION OF SINGAPORE

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UNDERSTANDING ENVIRONMENTAL, SOCIAL, GOVERNANCE (ESG) INVESTING AND STANDARDS

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ESG funds are portfolios of equities and/or bonds for which Environmental, Social and Governance factors have been integrated into the investment process. Some criteria for each category can be seen with the following examples:

Environmental: Corporate Climate Change policies that reduce carbon footprint

Social: Positive Workplace Conditions

Governance: Accurate and Transparent accounting methods and disclosures to its stakeholders

A positive rating suggests that the equities and bonds contained in the fund have passed stringent tests over how sustainable the companies or governments have been in meeting such criteria.

This should ideally be a clear direction for financial consultants to encourage our clients to pursue, since clients can enjoy the benefits of long-term financial growth while these companies provide positive social benefits.

However, criticism about ESG has become increasingly talked about over the last 1 year.

This should come to no surprise as ESG is ultimately a relatively new standard in the industry – for example, the S&P 500 ESG Index was only created in 2019.

It is important for consultants to take a hard look and objectively assess the criticism of ESG standards, as we cannot be responsible for blindly leading clients into such investments without giving them the full context.

This will enable consultants to make better presentations of the investments while ensuring that our clients have a clearer picture of their investments, ultimately preventing buyer's remorse and potentially achieving financial, possibly moral goals.
Here are a few key points to note about ESG Standards and Investing.

ESG is still New, and a 'Privilege'

For years, some prominent industries typically avoided by ESG have produced high above-market returns, such as defence and tobacco. This usually meant that a socially responsible investor would rarely see his investment decision more financially rewarding than not.

But as discussed in Tuesday Times Issue #77[1], it was only in recent times after decades of failure that sectors such as clean energy gained prominence and profits, especially attributed to youthful investment exuberance alongside technological accessibility to ESG investments.

This unfortunately means that if investment or spending power is down, and social responsibilities are unclear, we see significant drawdowns in ESG investing compared to general investing – something that is easily observable in this year of 2022.

For example, ESG rating firms face challenging questions over Russia, which total global oil exports were estimated to be over 7.5million barrels a day, powering many useful businesses that have found it financially challenging to find a substitution that doesn't hurt the business or environment.

High inflationary numbers have also resulted in lower earnings reports from many companies all around, which have led investors to desert those companies for safer or higher performing havens.

These include commodities such as oil and energy companies, which are generally frowned upon by ESG standards for their negative carbon emissions.

Consequently, ESG Fund sponsors and investors reported lagging performance and declining investment flows into ESG investing strategies as a result.

As pointed out in Tuesday Times Issue #78[2], many ESG categories still follow the Energy Trilemma – where affordability can take precedence over social good.

That is why high carbon emissions in emerging market countries such as China and India are often overlooked universally, as affordable energy is far more of a priority towards the citizen's livelihood than being able to address climate change.

It is important for investors to recognize that ESG investing may have similar ongoing problems in the future, as investing is typically a long-term commitment.

Are your clients prepared for potentially higher volatility in their investments in order to concurrently do social good while making money?

ESG is Subjective

The United States Transportation sector generates the largest share of greenhouse gas emissions in the entire country.

In the last two years of development, the growing use of Electrical Vehicles in the United States helped to avoid the need for roughly 1.5 million barrels of oil per day, according to new analysis from Bloomberg New Energy Finance.

From this information, one would think that Tesla – not just in the US, but the world's largest electric vehicle maker would be highly rated.

Instead, Exxon Mobil, the largest producer of oil and gas (and subsequently harmful carbon emissions) not only gained a higher rating than Tesla, but Tesla was also removed from prominent indices that list good ESG companies.

Naturally, this news was highly controversial and seemingly did not make sense.

Other news about huge discrepancies between ratings companies also shine light on ESG's subjectivity. MSCI rates AES Corp an ESG leader, but Sustainalytics rates it a high risk.

If ESG is an agreed upon standard of social responsibility practiced in businesses, how can there be such huge differences?
It's likely because ESG methodology is still very subjective. Different agencies prioritize the aspects of environmental, social and governance differently. They also put varying higher importance in methodology and analysis of the data.

For example, in Exxon Mobil's case they had a long history of being socially conscious. Exxon Mobil is a big favourite with Shariah-Compliant investments, which adhere to strong and well-established religious rules with huge social benefits.

This includes a strong refusal to invest in tobacco and pornography, or having financial business practices that do not exclude the Islamic religion.

While Exxon Mobil is clearly no favourite as an Environmentally conscious company due to the sheer nature of their business, the social aspect was strongly favoured.

Conversely, while Tesla's business directly contributes to bettering the environment, the social aspect was judged harshly from an analysis of their negative social practices in the workplace.

We can see that the elements of ESG can be very subjective depending on what is considered more important and it can be almost impossible, even foolish – to try to quantify the amount of social responsibility from a subjective morality.

Some might find the environmental aspects more important than the social aspects, and not have let Tesla enter its current predicament.

I've personally heard many consultants present Tesla as part of Technology Investment funds that are 'obviously' socially responsible investments, on top of potentially financially rewarding.

But truly good consultants need to be aware of the potential discrepancies before presenting investments in a certain manner. Should they found to be incorrect or at the very least, contextually incorrect – there could be negative repercussions.

It can be very damaging to a consultant's career to have a client accuse him/her of misrepresenting an investment as socially responsible, when ESG investments can have such range of subjectivity.

ESG should ultimately prioritize financial management

If ESG can be both financially unrewarding and unnecessarily subjective, is it still a good investment?

Fortunately, the answer is still 'yes' – especially in certain categories of investments.
One of the consistent criteria's in ESG assessment is a financial assessment of risks to the business, especially from governance analysis. Such a rigorous criteria can help investors avoid blowups that can occur when companies operate in a risky or unethical way.

For example, in 2015 Volkswagen was found to have manipulated their carbon output during pre-launch testing: its actual output was over 40 times more when released to the market.

This was a huge scandal caused by unethical business practices.

There were huge financial repercussions: on 13 March 2015 the price of it's stock was almost 244 Euros – within 7 months by 2nd October 2015 it had dropped to less than 92.4 Euros: over a 62% decline.

Strong ESG tests result in higher accountability, that could prevent these kinds of blow ups. There have been some positive preliminary results: a back tested analysis of the SNP500 ESG Index outperformed the standard SNP500 index for the majority of the time across the last 10 years.

This suggests that adding a consideration of social responsibility to the top 500 US listed companies can not only result in the added social responsibility for the world, but also higher financial benefits for investors than without it.

Data is a bit more conclusive on other investment areas, especially in high-yield bonds or government bonds.

This makes sense, since strong Governance assessment is a good seal of approval for consultants to recommend investment funds that are less likely to incur high default rates or to be plagued with governmental corruption – resulting in a lower likelihood of loss for our clients.

In conclusion, While ESG is not as straight forward as our clients might possibly perceive it, making our jobs harder – I do subject to you that it is our job as Financial Consultants to possess adequate knowledge in our fields when presenting or recommending investment solutions.

This includes the discretion that is giving to us from having earned our license, and a greater understanding of the points as listed above.
For example, if a client asks a tricky question in relation to the ESG status of a company, we should not only be capable of presenting how it's rated by credible agencies, but also to derive intelligent conclusions from it.

Data-driven companies like Facebook or Google should be judged more by their governance (e.g. do they have a history of abusing your privacy), compared to environmental impact.

We can, and should - use our discretion and knowledge to offer logical, high-quality advice while gaining credibility with our clients.
This can only increase their probability of financial success.

Luke Ho is a licensed financial practitioner.
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FOOT NOTES

[1]HTTPS://WWW.IFPAS.ORG.SG/FILE/ISSUE77.PDF
[2]HTTPS://WWW.IFPAS.ORG.SG/FILE/ISSUE78.PDF

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