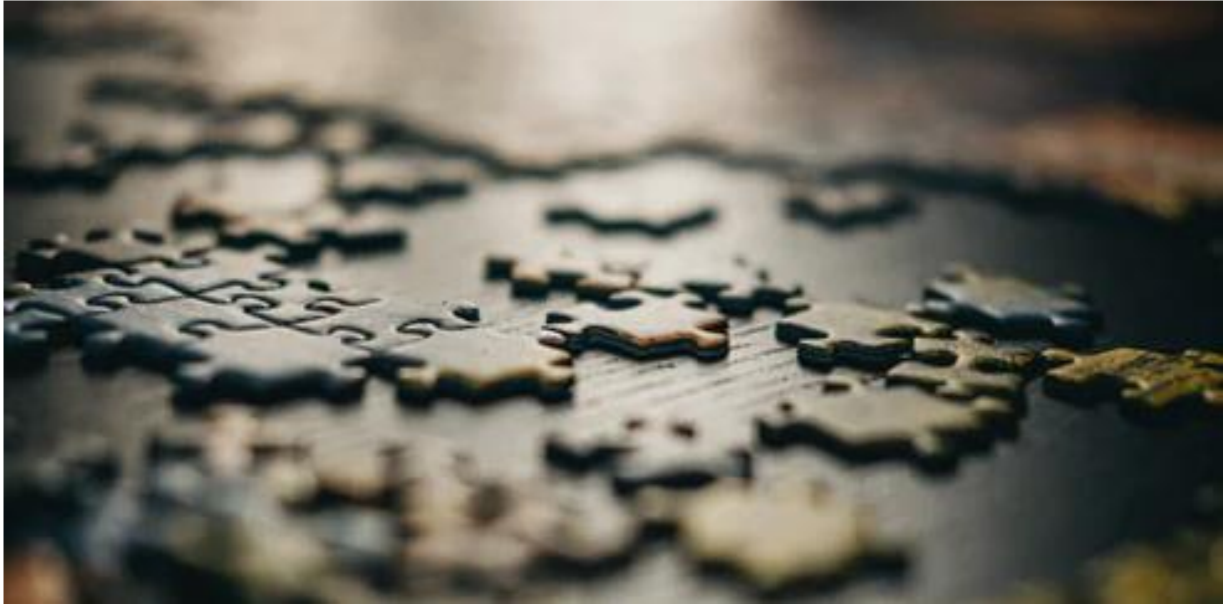

The ESG integration paradox

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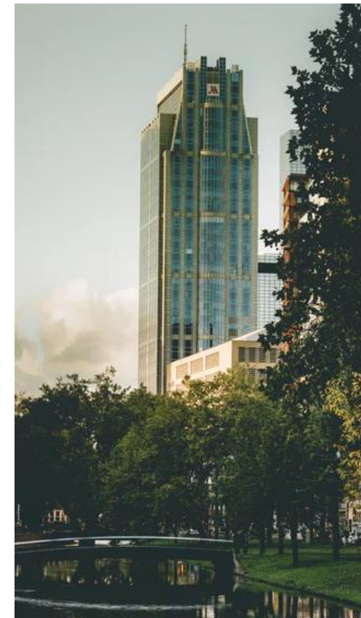
Mia Söderberg has more than 20 years of experience in the financial industry and is considered an ESG and sustainability investment specialist.

Today the concept of ESG and the benefits it can bring to the investment analysis is rather widespread. But there is still a large discrepancy in the understanding and the definition of sustainable investment. The added value in the evaluation of a company's risk profile, the sustainability profile of the company's operation in the long run, and future opportunities in a changing world – can create comparative advantages, and are all key parameters together with conventional valuation parameters in a well-made analysis of the return potential. The ESG framework, reporting and adjustments is getting ever so important for driving capital towards those who adjust and future-proof their operations.

In this rather light and prosperous future of sustainable investing there are obstacles and contradictions which are not always so easy to bridge. Some investors handle this by implementing strict exclusion lists and giving their manager a clear list of no-go companies and then have no problem with the rest of the universe. One could argue they choose the easy way out and sometimes provide the investment manager with not always comfortable handcuffs. Evaluating a manager and select the strategy with an investment process and historical performance based on a broad universe and then cap his universe and believe the outcome will be the same is rather opportunistic.

A company's sustainability efforts cannot easily be described in black and white terms. Companies do good things and can be very ambitious on one hand, but on another have some dubious operations. How should you take this into account? Which sustainability efforts are material for value creation for the company? Where to draw the line and what implications will that drag along?

A few examples to paint the picture.



Marriott – the hotel chain. They have a very ambitious ESG-plan and do some rather impressive work when it comes to transparency, gender equality and environmental enhancements making their hotel operation more sustainable. A clear time frame and plan for improving is in place, and they are driving the efforts in the hotel industry in a more sustainable direction regarding hospitality services. They have an advanced level of reporting and follow up on their achievements, leading the way showing how it can be done. About half of Marriott's top B2B clients, with large accommodation agreements have their own strict sustainability requirements and choose Marriott because of their focus on sustainability. Marriott's sustainability focus becomes a competitive advantage for the company. Together with a profitable and successful business model based on franchise and efficiency focus some investors consider it an interesting investment opportunity.

On the other hand, the hotel chain gets 8% of their revenues from alcohol sales – why many strict SRI investors exclude it. But is it unsustainable to sell alcohol in hotels? Is it rational to exclude an entire industry whose primary operation isn't alcohol sales but hospitality services and exclude the industry leader in sustainability in that industry as a result? I would argue that it is not a sustainability issue, more perhaps a moral or norms related. I would argue that alcohol producing companies, who often largely depend on their consumers unhealthy relationship to alcohol, inflicting problems to the society is a problem. The fact that the younger generation tends to drink less, will affect the revenues in the long run, and makes them even more unsustainable from an investment point of view. Working against demographic trends are rarely a sustainable business plan. But excluding hotels as part of a sustainable investing agenda, is it really a sensible thing to do? Could you as a result deteriorate your overall sustainable effect in your portfolio?

> " We wish to be a part of the solution, not only supporting those who already reached their targets but also those who are on their way in their transformation"
>
> - Sören Larsen, Head of ESG, Nykredit Asset Management

Safran – the French aviation industry company is another example. They have a minority defence manufacturing (generating 12% of their revenues) as part of their operations, the rest is focused on aerospace supply, such as landing gears and in the space sector high performance space optics etc. They also have an interesting helicopter and airplane engine development/ engineering section where they invest heavily in R&D to find solutions on the airplane pollution problem. They make engines with a 16-20% reduction of pollution and improvement of fuel efficiency, which most likely will be crucial for the ability to comply with the future regulation regarding air transport. The company invests heavily in engine engineering R&D and approximately 70% of their R&D investments are geared towards improving the environment profile of their products and services. The revenues from the defence division of the company, which are partially owned by the French government enables the

development of future solutions to the aviation industry. The global trend is not less flying, rather the opposite and we all know pollution from planes is a problem. We need solutions, but is it the solution to not invest in those who work hard to find them? To miss an interesting investment opportunity in a company creating competitive advantages by fuel saving and pollution reducing engines? This is not an easy topic with obvious answers.

> The meaning of *sustainable* is very fluid. What is considered a sustainable company or product today, might change tomorrow. What constitutes a sustainable investment for one investor, might be completely different for another. Hence it is crucial to understand your client's or organization's core values, investment beliefs and objectives and find managers and investment solutions that are most aligned with those. And be prepared for long discussions, as there are no quick and easy solutions.
>
> - Silva Dezelan, PhD
> Director Sustainability Robeco

So - what is the solution? For those who want easy solutions, a data set to merge into a spread sheet and get a number to run a quant screen or calculation - I have a disappointing answer, that will not be possible. In my view the key here is long and in-depth discussions, and to find a manager who truly understands sustainability and can make these decisions in a well-balanced manner. If you as selector do your homework with extensive research and long discussions with various managers you will find a manager with the right balance, who will focus on alpha and returns with ESG factors considered, managing your capital in the most appropriate way, in every holding and in every investment decision. When you find the suitable manager there will be less need for an extensive exclusion list and you will not be forced to handcuff your manager making him shrink his universe to fit in to a form he did not intend to fit into in the first place, risking to destroy his alpha and returns on the way. The integration paradox (excluding some companies on the exclusion list actually ending up deteriorating your chances to obtain a sustainable orientated portfolio) will still be there, and the contradictions will still make life difficult, but the manager will deal with it in an appropriate way without excluding the industry sustainability leaders. Alignment is key.