

What is the point of being 'ESG compliant'? Or the 'Famous 5' story may run and run?

02 May 2018 | Robert Swift, API Capital

This is a brief article and somewhat 'geeky'. It is not directly about the Hayne Royal Commission although will cite specific examples. It is more about Environmental Social Governance (ESG) 'analysis' and whether it helps investors or whether it is marketing 'spin'; or at least 'spin' as currently commonly used. For those of you not living in Australia, the Royal Commission into the banks (and the AMP, an insurance company) has revealed several embarrassing shortcomings and downright infraction of the regulations covering the provision of financial services. The Famous 5 to which we refer in the title, and which are currently embarrassed on a daily basis, are the 4 major banks and the AMP. It seems that shortcomings in process and incentives, ethics and the oversight of financial activities were not confined to everywhere but Australia after all.

We have a proposed solution to this and it is not more regulation, we already have plenty of that. It seems that these organisations are:

- Too large to manage internally – board diversity is great but how many board members have actually any idea how the provision of financial services operates and what is done by whom for whom to whom?
- Too large to regulate – they have achieved regulatory capture and are an effective lobby group
- Too large to prosecute – they can outspend the regulators on legal costs

Spot the common factor.

For the cynics (and oldies) amongst you we post a clip from the film Casablanca.

https://www.youtube.com/watch?v=SjbPi00k_ME

We too are "shocked" (sic) to find that the inherent conflicts of interest in such large, complex, and vertically oriented organisations haven't been supervised either by management; the board or the regulators. What a surprise to find that human beings working in financial services in Australia responded in the same way to the same incentives of 'carrot and stick' as the human beings in the same industries in the USA and the UK!

So often it is not the infraction that is the problem; people everywhere are wittingly or unwittingly committing a 'crime'. It is the (lack of) response to the infraction that is the problem. This too appears common to the 'Anglo Saxon' world. For more on why and how this culture has permeated listed companies then you should seek out work on executive compensation and share option incentives by Andrew Smithers. We can email you a copy if you wish?

The problem with being “shocked” at revelations is that you are probably too late and the share price has fallen, or falling precipitously at a rate that makes selling the shares even more expensive to clients? If you are “shocked” then your analysis has not picked up the risk and likelihood of this ESG shortfall ahead of the revelation? You would be shocked if a company was found to be cheating on its accounts but you might admit that you didn’t dig deep enough? Why is ESG any different if it is to be called analysis? Consequently, what is the point of ESG “analysis” if it merely results in a coordinated shareholder vote of protest AFTER all the damage has been done? It’s great to vote against the board after the event but hard to see how ESG compliance provides a competitive advantage if group think is prevalent? It’s great to be a signatory of the United Nations’ Principles of Responsible Investing (UNPRI) but not much practical use if you or they don’t speak up BEFORE the event?

Let’s move on to the point of the article. It is not about the Australian banks nor the Australian regulators but really about ESG and whether it is effective as currently applied.

ESG assessment is the ‘analysis’ of companies (and we hope governments since they issue bonds to the capital markets and take taxes) in the dimensions of Environmental Social and Governance responsibility. It is becoming increasingly important as a fund manager to have an approach to incorporate this aspect of capital stewardship. We do apply ESG in our own way, albeit with a particular emphasis on related G elements and Accounting policies rather than that of religious zealots where evil is everywhere and in everything.

We highlight below the ESG scores for the ‘Famous 5’ and show in context to other Australian financial service entities we evaluate as part of our stock assessment model. These have been drawn from Thomson Reuters database and are on a scale of 0 – 100 where 0 is pretty bad. The Thomson Reuters model is a fairly rigorous assessment and evaluates over 70 dimensions to arrive at a final score. There would appear to be no warning signals within all this information. Other approaches may have been better however given that we are all “shocked” at what has recently been revealed we doubt it.

RIC	ASSET_NAME	CTY	GICS_IG	GICS_IG_DESC	MC_USD	V_RANK	M_RANK	Q_RANK	VMQ_RANK	ESG_SCORE	E_SCORE	S_SCORE	G_SCORE
AMP.AX	AMP LTD	AU	4020	Diversified Financials	9270.5 M	77.59%	8.45%	27.00%	44.17%	76.9	88.8	70.9	70.7
ANZ.AX	ANZ BANKING GROUP	AU	4010	Banks	60347.3 M	80.97%	21.31%	33.10%	60.76%	92.7	90.3	90.8	97.6
ASX.AX	ASX	AU	4020	Diversified Financials	8273.1 M	26.00%	52.48%	86.93%	46.83%	71.4	65.3	76.1	72.8
BOQ.AX	BANK OF QUEENSLAND	AU	4010	Banks	3146.1 M	84.07%	5.10%	29.97%	54.21%	68.9	64.3	66.2	77.0
BEN.AX	BENDIGO & ADELAIDE BANK	AU	4010	Banks	3819.5 M	92.00%	7.07%	27.90%	63.72%	77.7	76.3	77.3	79.9
CGF.AX	CHALLENGER	AU	4020	Diversified Financials	4967.4 M	38.48%	5.90%	48.24%	16.52%	71.0	70.3	62.4	81.9
CBA.AX	COMMONWEALTH BANK OF AUS	AU	4010	Banks	97024.4 M	74.59%	13.28%	54.59%	64.86%	83.8	95.9	81.0	73.3
IAG.AX	INSURANCE AUSTRALIA GRP	AU	4030	Insurance	13616.1 M	59.14%	95.34%	74.00%	92.07%	84.2	78.1	93.3	80.3
MQG.AX	MACQUARIE GROUP	AU	4020	Diversified Financials	27358.4 M	88.79%	88.66%	52.97%	97.17%	88.7	97.9	85.8	81.9
MPL.AX	MEDIBANK PRIVATE	AU	4030	Insurance	5957.9 M	59.59%	29.55%	94.52%	81.10%	70.7	51.8	73.7	88.3
NAB.AX	NATIONAL AUSTRALIA BANK	AU	4010	Banks	58834.4 M	69.07%	14.34%	39.17%	45.76%	89.4	89.8	93.7	84.0
QBE.AX	QBE INSURANCE GROUP	AU	4030	Insurance	10288.0 M	51.21%	31.07%	17.48%	19.66%	62.6	73.9	61.7	51.1
SUN.AX	SUNCORP GROUP	AU	4030	Insurance	13475.8 M	68.83%	36.17%	8.07%	32.83%	70.7	79.4	58.7	75.0
WBC.AX	WESTPAC BANKING	AU	4010	Banks	74621.9 M	71.03%	13.66%	47.07%	55.28%	86.1	94.5	87.0	75.7
IFL.AX	IOOF HOLDINGS	AU	4020	Diversified Financials	2487.1 M	61.14%	20.93%	70.62%	64.07%	59.9	71.0	58.1	49.7

Now for the geeky bit. When we looked at the benefits of adding a new set of ESG factors to our existing model we discovered that there was positive correlation between the model and the ESG score. Having a positive exposure to the VMQ rank also meant we had a better than reasonable chance of having positive exposure to good ESG scores. In simple terms there was a positive non-trivial correlation which we show below.

The XY graph shows the trend line which is reasonably positive and the spread around the trend line appears wide but actually isn't. See us for some more geeky maths if you wish. The R-squared between the VMQ and ESG scores currently is 0.27.



In the following table of cross-sectional correlations, we show the average co-movement between the VMQ and the ESG scores. Not only are the V (Valuation) and E (Environment) scores related but the ESG scores themselves appear to duplicate each other. We have found that where V gets fooled is when G is poor and for this we always look to the accounting policies, auditing choice and board composition for further guidance and support.

Some would say this is merely what used to be called sensible research – whatever.

	V-RANK	M-RANK	Q-RANK	E-SCORE	S-SCORE	G-SCORE
V-RANK	1.000	-0.224	-0.235	0.254	0.175	0.113
M-RANK		1.000	0.254	-0.029	-0.003	-0.061
Q-RANK			1.000	0.063	0.110	0.064
E-SCORE				1.000	0.724	0.335
S-SCORE					1.000	0.403
G-SCORE						1.000

Consequently you can be ESG compliant even without explicitly applying ESG rankings.

Consequently you can be ESG compliant even without explicitly applying ESG rankings.

If you still want to have separate ESG scores from other factors you consider when selecting stocks, then here is the next conundrum. Having more factors to which you need positive exposure will increase portfolio turnover. If the ESG factors decay, that is if there is a need to keep refreshing your portfolio to get exposure to the ESG factor, you will increase turnover and transaction costs of your portfolio. If there is no decay of the ESG factor, how come it is an alpha factor to which you must have positive exposure? If it doesn't decay over time, it's not alpha.

It is fine of course to want positive exposure to ESG considerations. Just don't call it an alpha factor.

Our conclusions in a presentation we gave at a recent conference on the practical challenges of incorporating ESG into the investment process were:

- ESG is here to stay but there is plenty of evidence it doesn't add to returns or isn't alpha.
- Merely signing the UN PRI shouldn't count.
- It improves disclosure so we sort of like it. We believe however that we'd rather be amongst the first to assess if something is wrong so we can exit the position.
- Problems of coverage between regions and sizes of company. Cultural differences about behaviours and labour laws and 'engagement with officials' mean that MY ESG is probably culturally different from YOUR ESG. Consequently ESG is a form of cultural imperialism in which western values may be foisted upon cultures with different needs and challenges? If there is no schooling after the age of 16 in parts of the world, then 'child labour' may be the only way for the family to earn money? School leaving age was as low as 14 in the UK in the early part of the 1900s; some economies are at similar stages of development.
- Some well-loved companies have amongst the worst G scores – USA tech stocks have different voting rights and continually try to "pull a fast one" such as keeping the voting rights to stocks donated to charity! Nice try.
- There is no universal ESG 'truth'.

We will have to see if there are remedial actions taken by the buy-side after this Commission has finished. There probably should be.

Insights by Australian Fund Monitors Pty Ltd (AFM) provides investors and advisors with commentary and articles originated and provided by fund managers and other contributors. The views and opinions contained within each Insights article are those of the contributor and do not necessarily reflect those of AFM. www.fundmonitors.com.

Disclaimer: Australian Fund Monitors Pty Ltd, holds AFS Licence number 324476. The information contained herein is general in its nature only and does not and cannot take into account an investor's financial position or requirements. Investors should therefore seek appropriate advice prior to making any decisions to invest in any product contained herein. Australian Fund Monitors Pty Ltd is not, and will not be held responsible for investment decisions made by investors, and is not responsible for the performance of any investment made by any investor, notwithstanding that it may be providing information and or monitoring services to that investor. This information is collated from a variety of sources and we cannot be held responsible for any errors or omissions. Australian Fund Monitors Pty Ltd, A.C.N. 122 226 724

[CONTACT MANAGER](#)[VIEW PROFILE](#)