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Is Passive Investing killing ESG?

Societal Change

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Societal Change in Action

Social Anthropology probably isn't the first subject you think of when seeking to better understand the changing investment landscape, however, when looking at glocal societal change, it along with behavioural psychology are probably the two most advantageous disciplines to consult when making more informed and therefore more profitable investing decisions. This is because they help us understand why and how the world is experiencing faster rates and new dynamics of societal change which have never been seen before. These new dynamics have resulted in new correlations between previously uncorrelated phenomena.

As the worlds of commerce, finance, politics, social norms, and attitudes, etc become ever more correlated and interdependent as well as divergent due to technology this in turn gives rise to these interdependent systems being more prone to significant changes and challenges arising from regular and unchanged human activity. In short, human activity has remained pretty constant throughout the years, but its impacts are now felt on a much wider scale than before due to shared consequences and shared experiences. For example, the act of adhering to a certain type of diet like veganism or vegetarianism has always existed, however, coupled with social media, vegan alternatives have transformed business offerings and have even ignited a new multibillion-dollar industry.

Factors such as rising living standards, open trade borders, technological advancements, and global connectivity, and information sharing among others are impacting the way people are living, thinking, and consuming. Essentially, due to the above factors, citizens and consumers are becoming more informed which is altering their buying behaviours and consequently are demanding a lot more from their government and business to reflect their needs and attitudes in the policies they enact and products they produce. This is perhaps the essence of the glocal world we are living in, where both governments and industry need to understand, anticipate, and respond to the growing needs and wants of the people. Their voice will only get more powerful and spread more widely.

As investors, it imperative that this brave new world be investigated and understood in order to form a more precise understanding of societal change and consequently the affects it has on the investment landscape.

Shareholder Activism in the Age of ESG Policy

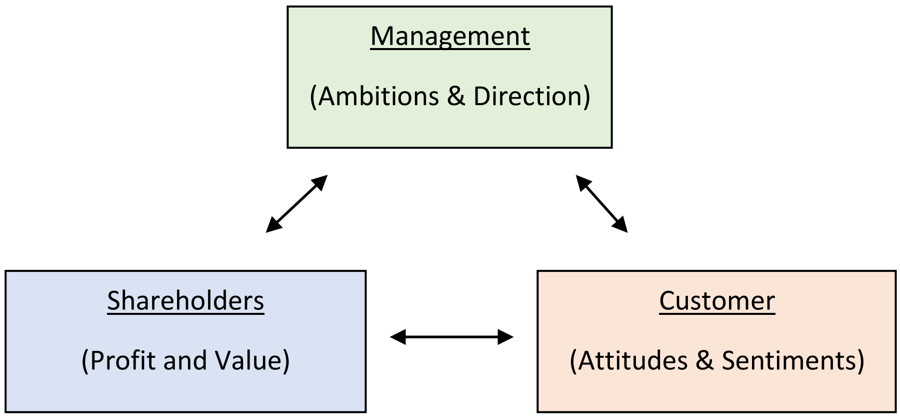
To curb what is today called agency problems, shareholder activism is deployed in order to help company leadership make better decisions for shareholders. This in turn allows markets to operate more efficiently and effectively.

This has been historically true, in fact, Adam Smith in his seminal work *The Wealth of Nations* highlights that since the directors of these companies manage 'other people's money…negligence and profusion…must always prevail, more or less, in the management of the affairs of such a company.'

However, this is not the only relationship a listed business has to manage. Increasingly the attitudes and sentiments of customers are playing a larger role in the direction and character of companies.

Whether rightly or wrongly, listed companies are compelled to develop stances and opinions on social issues. Additionally, and on a deeper level, consumer are expecting companies to reflect in their operations, actionable initiatives that reflect the concerns and aspirations of their consumer base, this is especially true and relevant for industries that are seen as exacerbating a social cause, for example the fashion industry and ecological denigration.

<u>The Business Triangle</u>



ESG is the umbrella title that loosely brings the concerns of environmental, social and governance issues together. A movement that started at different stages for different issues has now presented itself to the business and investment community as valuable criteria to follow when businesses make practical growth decisions and as criteria by which investors should judge the public utility of a company alongside its profitability.

Leaving aside the much talked about shortfalls of current ESG standards by which we measure businesses against and metrics by which investors evaluate the efficacy of these measures. It seems as if ESG speculation has now in fact become an industry onto itself, citing for example the creation of new analytics for investors, to the plethora of conference, summits, roundtables that discuss ESG, to new divisions in companies and investment firms that are tasked with creating, implementing and measuring ESG guidelines to ESG auditing and consulting and much more.

Whatever we collectively decide ESG is and how we measure it, its evolution and implementation will inevitably come from the interplay between the three players of the business triangle and in particular the effects of shareholder activism on management. Although, for some who believe ESG is a hindrance to profitability or at the very least an unwelcomed distraction from primary business operations, the thought that those who have no vested interest in the business such as the vague notion of public opinion does not sit well. The unchanged doctrine that a business must do what is best for the shareholders, for it is the shareholders money which management is responsible for and only active shareholder voices coupled with clear government policy can and should direct the activities of a company.

How is passive investing impacting ESG policy implementation?

Starting with the premise that a company is in business to make money and assuming the position that ESG policy implementations contributes to the long-term longevity and prosperity of a company, we can then dissect the main differences between active versus passive management in relation to ESG. Although it is also helpful to note that this divide is not binary and that there is a spectrum of investment vehicles that range from purely passive index investing to independently active investing.

The main aspect which differentiates passive and active management in relation to ESG is that active managers have a mandate from their clients to engage with management of listed companies to fully flesh out their ESG vision and framework for the ultimate benefit of a positive stock price. This mandate is built into the fees charged by active managers who pursue an informational advantage to their competitors by conducting market research on fundamental aspects that can positively impact the stock price. They also have a direct line to company leadership to help shape company policy and deter agency problems.

Passive investing on the other hand does not have a mandate from clients. A passive funds aim is not to have an informational advantage of which to trade from, but rather is based on the notion that it is extremely difficult to beat the market at a cost effective rate for the client, therefore no money or resources are allocated to market research or management engagement. Gaining market return is the most cost effective and consistent way to profit according to passive fund providers. Due to the lack of engagement with management, passive funds cannot shape what they consider as effective ESG policy for the companies in their fund. This lack of investor accountability is giving management more independence in how they go about shaping their ambitions and direction, but if not incentivised by investors, companies according to Adam Smith risk neglecting their ESG responsibilities or may pander to the fog of public opinion.

When considering the prevalence of passive fund providers over the years, for example in Europe where net inflows into European passive funds in 2016 – both index funds and ETFs – totalled $83 billion, outpacing the $48 billion netted by their active peers. It is easy to extrapolate the effects of this black noise coming from passive funds and its impact on ESG policy.

Although there are passive funds with ESG considerations such as the Vanguard ESG Developed World All-Cap Equity Index & Vanguard ESG Emerging Markets All-Cap Equity Index funds, this still does not mitigate the fact that the true aim of ESG is to build a philosophy of positive environmental, social and governance principles for all companies to engage in, and to use the voice and leverage as a shareholder to hold companies to account to these standards. It is not simply an exercise of excluding or screening out companies which are involved in non-renewable energy, weapons, and 'vice' products such as gambling, tobacco and alcohol.

Furthermore, it is not just ESG that passive funds are having an impact on. Studies have shown that passive investing is having an adverse effect on company innovation, M&A and investment strategy. For example, Aghion, Van Reenen, and Zingales (2013) found that innovative activity increases as the share of non-fund ownership increases. Furthermore, Schmidt and Fahlenbrach (2017) examine the link between value-destroying M&A activity and the active/passive split in share ownership, and find that as the proportion of passive ownership increases, management becomes more entrenched (as measured by the accumulation of job titles) and that the probability that a firm indulges in value-destroying M&A activity increases. Finally, Gutierrez and Philippon (2017) examine the impact of the proportion of passive ownership on investment behaviour. They find that firms with a higher proportion of passive ownership invest less and pay out more. These shortfalls can be attributed in large part by the lack of accountability of passive funds but also the unexamined and lack of fundamental analysis that is required for efficient and effective markets to prevail.

The fate of ESG seems to lie in either the efficient underperformance of active shareholders who consider ESG a priority or the inefficient average performance of passive funds who are trying to cater to ESG conscious investors. Either way, there is still a lot that must be done for ESG to be incorporated into the business and investment architecture.

Further Research Questions

Below is a list of questions and themes we have investigated and think you would like the answers to.

1. Are ESG conscious companies really more profitable over time, or Is it a self-fulfilling prophecy?
2. What industries are more likely to benefit from ESG policies?
3. Where in the world is ESG investing the most prevalent and least prevalent, and why?
4. How does ESG playout in the private equity space?
5. How valid are current ESG investment rating metrics?
6. What are the primary KPIs that investors and businesses measure the impact of ESG policy?
7. Where is the drive for ESG considerations coming from?
8. Why is there such disparity between the adoption of ESG measures by institutional investors?
9. What is the difference between ESG and impact investing, and why is it important?
10. What role(s) do government and regulators play in the ESG debate?

Research delivery

Our team is happy to discuss your needs for further insights into the topics above, or any other questions you are asking. Below are our four ways we typically work with clients.

Commissioned Research This can vary in from a snap-shot one-page overview of a current development to an extended piece of research	**Expert Briefings** Delivered in seminars and boardrooms, which gives opportunities both for structured analysis and the free exploration of issues of related interest to clients
Consulting This offers a “deep dive” discussion angle for clients rather than a written report or a formal briefing into the questions they need answering	**Public Speaking** Formats include Keynotes, Q&A, Fireside Chats, Panels.

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