EDGEPOINT®

Your ESG fund is part of the problem

By Sydney Van Vierzen, investment analyst

ESG – making the world a better place

In recent years, Environmental, Social and Governance (ESG) investing has become the topic du jour for many people. They're spending more time contemplating the impact that companies have on the world and what that may mean for the future. These views are increasingly influencing the way individuals and organizations think about investing.

Many fund companies get very excited about trends like ESG because it's an opportunity to sell new products. With most fund companies being run by salespeople, it should come as no surprise that these products tend to be more about marketing and less about substance. Many such funds rely on shortcuts like ESG ratings, exclusionary rules and other approaches that a business-minded investor would never rely on to invest money that's earmarked to feed and shelter their family.

Our approach at EdgePoint has always been centered around the idea of investing like a business owner. We focus on making rational decisions in order to compound wealth, and we see no reason to approach ESG differently.

In our view, the definition of ESG revolves around making the world a better place. There's a growing opportunity in the markets today to take advantage of investors who don't always think for themselves. By thinking like business owners and acting rationally, we see an opportunity to contribute to a better future while delivering material financial gains to our end investors.

The purpose of this commentary isn't to discourage investors from ESG, but instead to highlight some of the challenges that we see today. As always, our goal is to help inform our investors and equip them with the information that we believe is essential when making investment decisions.

ESG ratings – scoring the undefined

Many are probably familiar with the concept of ESG ratings. There are dozens of different ESG rating agencies today that score companies on various factors in an attempt to quantify "ESG risk."

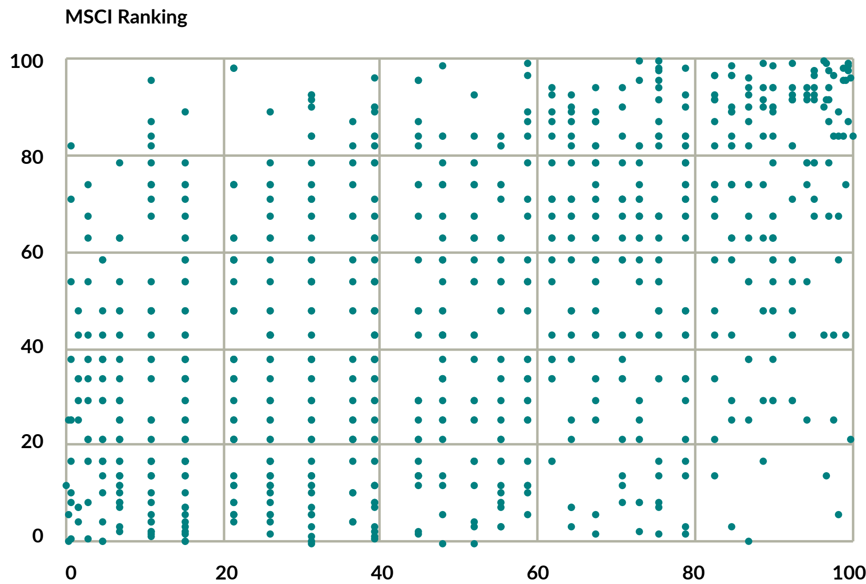
Unlike the credit rating agencies where risk for fixed income investors is clearly defined as the risk of not being paid back, the definition of ESG risk isn't as transparent or standardized. It can be financial risk, reputational risk, operational risk, some combination of these or something completely different!

Part of the challenge comes from defining what factors are even relevant, as each agency has its own opinion on what ESG means and how to measure it. If this wasn't enough, these agencies then must decide subjectively how different factors compare to one another in terms of importance. Is corporate diversity a bigger risk than supply chain labour standards? How do these issues compare to electronic waste and community relations? If you ask 10 rating agencies to rank ESG risks in terms of importance, you might get 10 different answers. Without a clear definition of what risk is, how do you compare these issues objectively?

The best way to depict the confusion of ESG ratings is by simply comparing the ratings of the two main agencies, MSCI and Sustainalytics. The following table shows the ESG rating for 878 U.S. companies. Each blue dot represents a company while the y-axis is MSCI's rating and the x-axis is Sustainalytics' rating. Companies that MSCI ranks highly, represented by a higher number on the y-axis, are frequently rated much lower by Sustainalytics, and vice versa. This compares to credit ratings that have a correlation above 0.90[i] – meaning they are highly consistent across firms, which allows for more accurate comparisons.

MSCI vs. Sustainalytics rankings

Start of 2019



Data: Overall ESG ratings from MSCI and Sustainalytics for 878 U.S. companies. Source: MSCI and Sustainalytics; analysis by Dimson, Marsh and Staunton. Not to be reproduced without express written permission from the authors.

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Source: Elroy Dimson, Paul Marsh, Mike Staunton, *Credit Suisse Global Investment Returns Yearbook 2020 Summary Edition*. March 2020.
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This isn't to say that ESG rating firms don't provide value. In fact, they can be very helpful in some regards. We subscribe to them because they are much more than just a ratings agency. These companies provide substantial research and historical information for businesses that can help us in both researching and monitoring investments. We incorporate them into the extensive research we do on each business in order to form proprietary insights, and supplement them with our own views of the business. As rational business owners we have dedicated time and effort to also understand how the ratings are constructed and how the research is performed in order to know why our businesses are rated a certain way. The problem is that many investment funds don't use the underlying research and, instead, make decisions blindly based only on the ESG score that the agencies publish. If a firm charges you a fee to manage your money but outsources the decision making, it's not an investment firm, it's a marketing firm.

Exclusionary investing – ignoring the problem

The exclusionary approach to ESG investing starts by defining unwanted industries and then excluding them from the investment process. Industries that are frequently excluded include coal and nuclear power, oil & gas, tobacco, etc.

Most people know that ignoring a problem rarely makes it go away and, in many cases, actually makes it worse. This lesson can also be applied to investing. By ignoring a "bad ESG actor" like an oil & gas company, you don't reduce global demand for oil, you don't make these companies magically disappear and you don't make the world a better place. By ignoring a company, you impair its access to capital and limit its ability to change and adapt, ensuring that it will be a bad actor for as long as possible. You also miss an opportunity to actually make a difference in the world.

We're witnessing incredible ingenuity from Canada's oil and gas sector as a handful of companies look to become global leaders in carbon capture, transportation and storage. Many would consider this to be the pinnacle of ESG technology, and yet these same companies are considered non-investable according to many exclusionary ESG frameworks. If this apparent contradiction confuses you, don't worry – it confuses us, too.

Investing in the rear view

We often say that investing is done best when it's most businesslike. Part of investing with a business owner mindset is thinking about the future relative to today and asking questions like, "How much am I being asked to pay today?" and "What do I get in the future?" This touches on what may be the biggest weakness in ESG today, whether it's rating agencies, exclusionary rules or just general narratives: all of it is backwards looking with a greater focus on the problem instead of the solution, which is a bit ironic if you think about it.

An example of this is TransAlta, a Canadian power-generation company and an EdgePoint investment. TransAlta is one of the largest power generators in Alberta, and it also operates one of the largest fleets of coal power plants in the country. As you would probably guess, TransAlta is not considered a leader in ESG. In fact, it sits squarely in the "untouchable" category for most ESG mandates. This makes sense if we think about the company's history, but what if we asked the simple question, "How will they make the world a better place?"

TransAlta is in the process of converting its entire Alberta coal fleet to natural gas. This will reduce the company's annual carbon emissions by roughly 30 megatonnes (one megatonne equals one million tonnes).[ii] As a country, Canada has committed to reduce greenhouse gas emissions by 220 megatonnes below our 2005 levels.[iii] The actions of TransAlta alone represent almost 14% of the target for the entire country. We challenge you to find a company that will contribute more to the cause.

TransAlta is a reminder that the biggest opportunities come from companies that are typically seen as the biggest problems, and herein lies a major shortcoming of ESG today. Transformations, such as the one that TransAlta is undergoing, require capital, and that capital isn't being provided from ESG-focused investors. In fact, the strategy to date for ESG investing has often been the opposite – ignore the problem and hope it goes away.

What to expect from EdgePoint

When making a decision at EdgePoint, we frequently think about Warren Buffett's newspaper test. If we knew our decision would end up on the front page of the local paper for all of our family, friends and neighbours to read, would we still make it?

What you should expect from EdgePoint is that we will continue to act as a rational businessperson would, and that we will continue to make decisions we'll feel good about looking back – even if we don't make it to the front page.

While ESG has been a part of our investment approach since day one, we constantly strive to learn and improve. As part of that continuous improvement, we've added new resources and enhanced our processes through the establishment of a dedicated ESG team.

With these new resources, we've been able to engage in new ways with the management teams of our investments, to help them with their own ESG challenges, whether it's best practices, corporate governance, reporting or otherwise. This is creating an opportunity for us to help make these companies better and, in turn, grow the wealth of our end investors as the world also becomes a better place. To us, this is ESG investing.

[i] Source: Joachim Klement, "Navigating the ESG Rating chaos", *Klement on Investing (blog)*, October 31, 2019. https://klementoninvesting.substack.com/p/navigating-the-esg-rating-chaos.

[ii] Source: TransAlta corporate reporting.

[iii] Source: Government of Canada, "Progress towards Canada's greenhouse gas emissions reduction target", March 3, 2021. https://www.canada.ca/en/environment-climate-change/services/environmental-indicators/progress-towards-canada-greenhouse-gas-emissions-reduction-target.html.

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