



## ESG'S RUSSIA TEST: TRIAL BY FIRE OR CRASH AND BURN?

In the eye of the beholder!

# My Priors on ESG

- I believe that ESG is, at its core, a feel-good scam that is enriching consultants, measurement services and fund managers, while doing close to nothing for the businesses and investors it claims to help, and even less for society.
- That judgment be harsh, but as the Russian hostilities in Ukraine shake up markets, the weakest links in the ESG chain are being exposed, and as the same old rationalizations and excuses get rolled out,
- I believe that a moment of reckoning is arriving for the concept. If you remain a true believer, I will leave it up to you to decide how much damage has been done to ESG, and what comes next.

# Russia invades Ukraine: The ESG Test

- ❑ When Russian troops advanced into Ukraine in late February, the reverberations across markets were immediate. Stock, bond and commodity markets all reacted negatively, and at least initially, there was a flight to safety across the world.
- ❑ Since one of ESG's sales pitches has been that following it's precepts would insulate companies and investors from the risks emanating from bad corporate behavior, both ESG advocates and critics have looked to its performance in this crisis, to get a measure of its worth.
- ❑ I am not an unbiased observer, but the reactions from ESG defenders to this crisis can be broadly categorized into three groups.

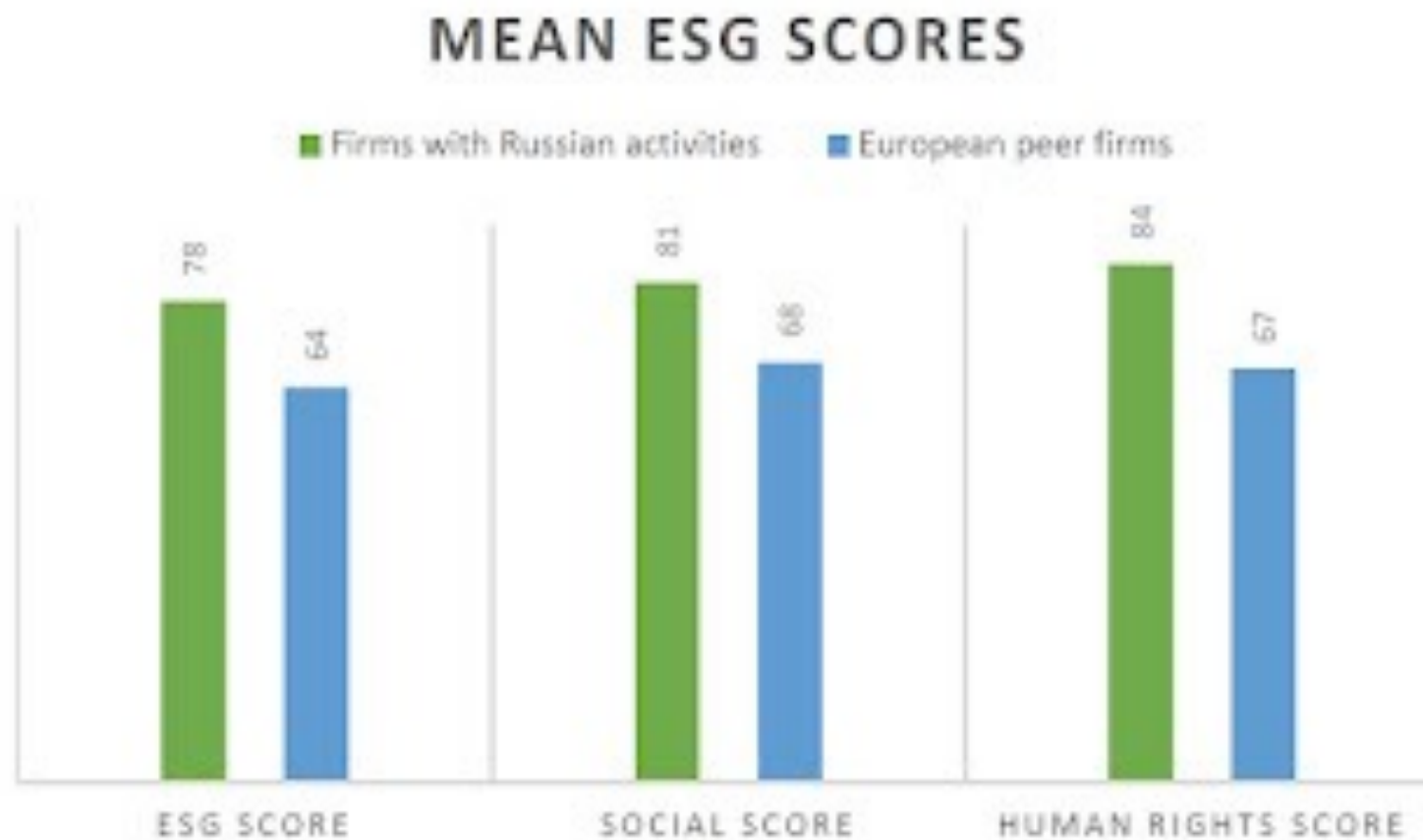
# I. The Revisionists

- In the last decade, as ESG has grown, I have been amazed by the capacity of some of its advocates to attribute everything good that has happened in the history of humanity to ESG.
- If these ESG revisionists are to be believed, if companies had adopted ESG early enough, there would have been no banking crisis in 2008, and if investors had screened stocks for ESG quality, they would not have lost money in the corporate scandals and meltdowns of the last decade.
- In the last week of February 2022, in the immediate aftermath of this crisis, there were a few ESG supporters who argued that ESG-based investors were less exposed to the damage from the crisis. That was quickly exposed as untrue for three reasons.

# 1. ESG's Russia Miss on Measurement

- There is no evidence that Russia-based companies had lower ESG scores than companies without that exposure.
  - In my last post, I looked at four Russian companies, Severstal, Sberbank, Yandex and Lukoil, all of which saw their values collapse in the last few weeks.
  - When I checked their ESG rankings on Sustainalytics ranked each on February 23, 2022, each of them was ranked in the top quartile of their industry groups, though they all seem to have been downgraded since, with the benefit of hindsight.

# More general evidence...



# ESG's miss on performance

- It is true that the emphasis on climate change that skews ESG scores lower for fossil fuel and mining companies would have kept you from investing in Lukoil and Gazprom, among other Russian commodity companies, but it would also have kept you from investing in other companies in these sectors, operating in the rest of the world; that would have kept you out of the best performing sector since Russia invaded Ukraine.
- ESG funds/lenders lost substantial amounts in Russia: Investment funds and lenders who have long touted their ESG credentials do not seem to have been less exposed than non-ESG funds, early reports notwithstanding. A Bloomberg Quint study of ESG funds uncovered that they had \$8.3 billion invested in Russian equities on February 23, 2022, almost all of which was wiped out during the next few weeks. In fact, the saving grace for ESG funds has been the fact that Russia did not have a large investable market, for both ESG and non-ESG funds.

# The Abandonment of Russian Operations

- In the weeks after the war, hundreds of US and European companies have announced that they were leaving Russia, and ESG advocates have pointed to this exodus as evidence that its practices are now mainstream. I disagree.
  - Small presence in Russia: Other than oil companies, most of the companies pulling out of Russia are not giving up much business to begin with.
  - Risk Surge and Economic Viability: Many companies that invested in Russia, when it was lower-risk destination, have woken up to a new reality, where even if their Russian projects return to profitability, the returns that they can deliver are well below what they need to make to break even, given the risk. It is easy to pick the moral path, when economics and morality converge.
  - Suspension versus abandonment: It is telling that many companies that have larger interests in Russia, with perhaps the possibility that investing will become economically viable again, have suspended their Russian operations, rather than abandoning them.



# A Thought Experiment

- For those who continue to insist that the corporate reaction to the Russian invasion is a sign of moral awakening at companies, I propose a thought experiment.
  - If China had invaded Taiwan, do you think that companies would have been as quick to abandon their Chinese holdings and business?
  - Do you think that investment funds would have been so quick to write off their Chinese holdings?
  - On a more personal level, would you be willing to give up all things “Chinese”, as quickly as you were willing to give up drinking Russian vodka?

## II. The Expansionists

- There are a few in the ESG movement who have argued that the fix is to expand the definition and measurement of ESG to incorporate Russia-like risks.
  - ▣ It will mean bringing in the nature of governments into ESG measures, with companies in countries with authoritarian governments getting lower ESG scores than companies in countries with democratic governments.
  - ▣ If you go along with this, it will mean that every ESG measurement service will have the unenviable task of assessing political freedom (or its absence) in a company's operating geographies, to evaluate its ESG score. **Ultimately, if ESG tries to measure everything, it ends up measuring and meaning nothing.**
- In the weeks right after the war started, two Citigroup analysts suggested that companies making weapons be classified as good companies, as long as they were selling them to the “right” side of the conflict. While ESG advocates were dismissive, I think that what the Citigroup analysts were proposing is more in line with the true nature of ESG, an amorphous, anything goes and elastic concept that shifts shape and form, depending on who is defining it, and when.

# III. The Utopians

- There is a group within the ESG movement that has been unfazed by any critiques of ESG or evidence that it has not done what it set out to do.
- To these true believers, the problems with ESG come from it being misappropriated, mis-measured and misused, and in their view, ESG, done right, will always deliver its promised rewards.
- I call this group the "if only" chorus, since in their view, if only services measured ESG correctly, if only companies did not indulge in greenwashing, and, if only, ESG funds did not pick under performers, ESG would work at making the world a better place.

# They are wrong because...

- ESG mis-measurement is endemic, not transient: Even ESG measurement services are willing to admit that the [current ESG ratings for companies are flawed](#), but they all contend that better measurement is around the corner, premised on two assumptions. The first is that ESG disclosures will improve, as regulators force companies to reveal more about their environmental and social performance, and that this data will improve measurement. The second is that as ESG ages, we will develop consensus on what comprises goodness, and when that occurs, there will be a higher correlation across services
- Greenwashing is an ESG feature, not a bug: There is probably no phenomenon on which there is [more handwringing among ESG types than "greenwashing"](#), where companies substitute "looking good" for "doing good". I am willing to take a wager with any ESG true believer that the more ESG services and regulators try to crack down on greenwashing, the more ubiquitous and sophisticated it will become. The largest and most profitable companies will have the resources to game the system better, exacerbating biases that already exist in current ESG scores.
- ESG Investing underperformance is steady state, not a passing phase: In steady state, once the components of ESG that matter get priced in, ESG-constrained funds will deliver lower returns than funds that don't operate under those constraints. As I noted in one of my earlier posts on ESG, arguing that a constrained optimal can consistently beat an unconstrained optimal is sophistry, and the fact that some of the biggest names in the investment business have made these arguments tells us more about them than it does about ESG.
- ESG is not about actual change, but the perception of change: Some of ESG's biggest "wins" have been in the fossil fuel space, with [Engine Number 1's success in forcing Exxon Mobil](#) to adopt a smaller carbon footprint, being presented as a prime exhibit.? In fact, all that ESG activists have managed to do is move fossil fuel reserves from the hands of publicly traded oil companies in the US and Europe, who would feel pressured to develop those reserves responsibly, into the hands of people who will be far less scrupulous in their development. If this is what winning looks like in the ESG world, I would hate to see what constitutes losing!

# The Next Big Thing! A Cynical Guide...

- Give "it" a name: Give your next big thing a name, and pick one that sounds good, and if you want to add an aura of mystery, make it an acronym, with three letters seeming to do the trick, in most cases.
- Give "it" meaning and purpose: As you write the description of the word or acronym, make that description as fuzzy as possible, preferably throwing in the word "long term" and "good for the world" into it, for good measure. (See step 5 for why this works in your favor.)
- Use history to reverse engineer it's components: Before you add specifics to your description, examine business and investing history, focusing on the most successful, and looking for characteristics that they share in common in terms. To round "it" out, you should also find failures and see what common features bind them together. Then incorporate these characteristics into your description, with the shared features of successful companies as your must-haves, and those of the failures are things to avoid.
- Use self-interest to sell "it": To get the business establishment behind you, draw on its powerful drivers, self interest, greed and self delusion. If you have done your job well in step 3, you will have no trouble gaining institutional support, since you have already primed the pump. Case writers and consultants should have no trouble finding supporting cases studies and anecdotal evidence, academic researchers will unearth statistical evidence that your concept works and investment fund managers will unearth its capacity to create "alpha" in past returns.
- Delay and deflect: If you get pushback from critics or those with evidence that is contradictory, attribute failures to growing pains and argue that what is needed is a doubling down of fidelity to the concept. Since you have provided no clear or even discernible targets, you can always move the goalposts or claim to have accomplished what you set out to, and thus not be held accountable. Finally, use the "goodness" shield, since that makes any questioning of your big idea seem small minded and mercenary.

# Could this be “it”?

- So, what will the next big thing be? I don't know for sure, but I am willing to make a guess, since so many ESG experts and advocates have slipped into already using it as an alternative. It is "*sustainability*", a word that can mean whatever you want it to mean.
  - In its most benign form, I believe that it is just another word for "long term", though the only benefit of replacing one set of words with another is that it offers a chance for those using the new and updated word to state the obvious, claim the outrageous and charge the absurd.
  - In its more malignant form, it becomes a way to try to keep corporations alive forever, a dreadful idea, where zombie and walking dead companies suck up capital and resources, and drag the rest of us down into the abyss with them.

# Useful Idiot or Feckless Knave?

- When I first wrote about ESG two years ago, I believed that it was a flawed concept that needed fixing , but after two years of interactions with people who claim to know the concept really well, but don't seem to be capable of making a solid case for it, and witnessing its takeover by well heeled entities with agendas, I am convinced that there will soon be room for only two types of people in the ESG space.
  - ▣ The first will be the useful idiots, well meaning individuals who believe that they are advancing the cause of goodness, as they toil in the trenches of ESG measurement services, ESG arms of consulting firms and ESG investment funds.
  - ▣ The second will be the feckless knaves, who know fully well the void behind the concept, but see an opportunity to make money. I know that those are not edifying choices, but I don't see any good ones, other than leaving the space already.