



### **What to make of “ESG” investing?**

***In this and future versions of our quarterly update, we will include some additional thoughts on topics that we think are relevant to Lee Turner clients, or about which we have received questions, but don't fit the other sections.***

The big “new” thing in investing in the last few years—and which shot to prominence during COVID—is “sustainable” or “ESG” investing (environmental, social, and governance investing). The premise is straightforward: companies have avoided shouldering the costs of their negative impacts on society, on the environment, and on various stakeholders and now the bill is coming due. In many ways, the trend is not new at all. Investors have voted with their dollars for decades with some choosing to avoid investing in “sin stocks” like tobacco and avoid investing in certain objectionable locales (such as South Africa during apartheid). One could argue that the sins have simply been redefined but unlike prior versions, this new strain of responsible investing argues the strategy has less to do with aligning a portfolio with a person’s *values* and far more to do with realizing financial *value*. To invest sustainably, the argument goes, you should avoid investing in certain risky companies—those with the greatest environmental, social, or governance risks—and thus generate market outperformance.

On paper, this seems prudent as all investors want to avoid taking on additional risk without commensurate return. But the results are mixed. For one, defining an “ESG risk” and ranking it against others is no easy feat. How should you compare a data breach with an oil leak, for example? Secondly, linking that social or environmental risk to a company’s performance is also tricky. Finally, these risks change over time. In practice, it is even more difficult to see whether asset managers focusing on ESG investing are really doing anything. Below are the top 20 holdings and weights for SPY, the largest exchange traded fund (ETF) tracking the S&P 500 index, and iShares MSCI ESG Aware USA fund, the largest ESG ETF in the US market. See if you can identify which fund is considering sustainability and ESG concerns, and which is not.

1	Apple Inc.	5.80%	Apple Inc.	5.71%
2	Microsoft Corporation	5.57%	Microsoft Corporation	5.12%
3	Amazon.com Inc.	4.10%	Amazon.com Inc.	3.80%
4	Facebook Inc.	2.28%	Facebook Inc.	2.01%
5	Alphabet Inc.	2.04%	Alphabet Inc.	1.98%
6	Alphabet Inc.	2.01%	Alphabet Inc.	1.83%
7	Berkshire Hathaway Inc.	1.45%	Tesla Inc.	1.38%
8	Tesla Inc.	1.45%	NVIDIA Corporation	1.37%
9	NVIDIA Corporation	1.33%	JPMorgan Chase & Co.	1.23%
10	JPMorgan Chase & Co.	1.28%	Visa Inc.	1.10%
11	Johnson & Johnson	1.19%	Johnson & Johnson	1.02%
12	Visa Inc.	1.11%	The Home Depot Inc.	1.00%
13	UnitedHealth Group Incorporated	1.04%	The Walt Disney Company	0.95%
14	PayPal Holdings Inc.	0.96%	Mastercard Incorporated	0.89%
15	The Home Depot Inc.	0.92%	Adobe Inc.	0.89%
16	Mastercard Incorporated	0.91%	PayPal Holdings Inc.	0.87%
17	The Walt Disney Company	0.90%	Bank of America Corporation	0.87%



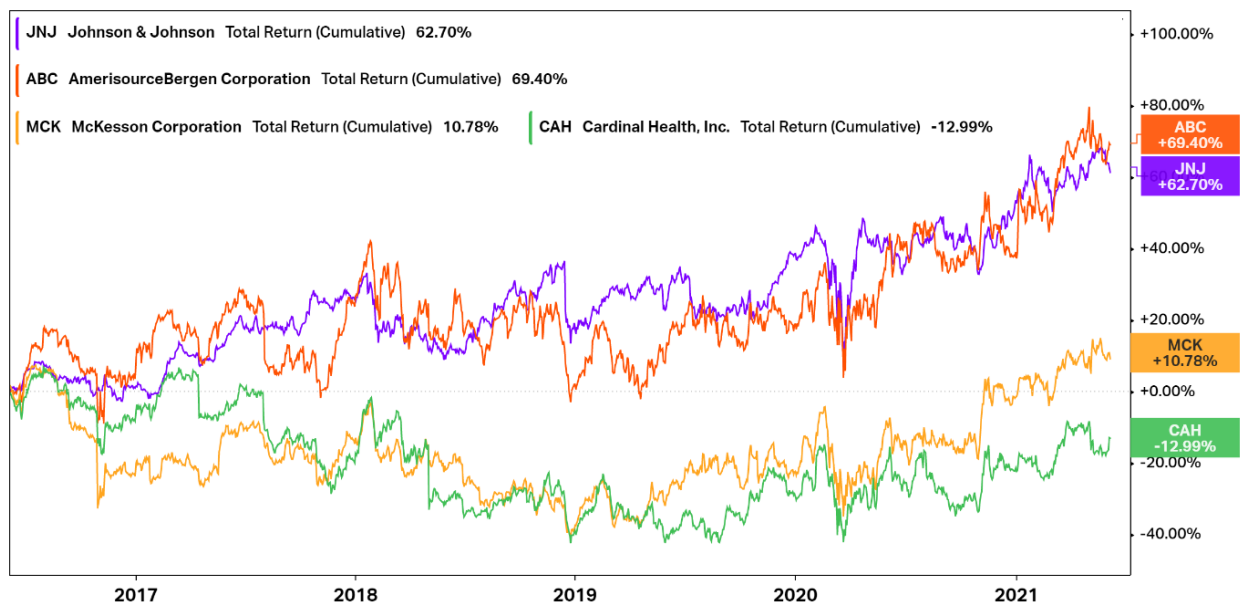
18	The Procter & Gamble Company	0.90%	UnitedHealth Group Incorporated	0.85%
19	Bank of America Corporation	0.85%	The Procter & Gamble Company	0.81%
20	Adobe Inc.	0.77%	Berkshire Hathaway Inc.	0.80%

Koyfin data; June 29, 2021

Turns out ESGU is the fund on the right, but aside from the modest demotion of Berkshire Hathaway from 7<sup>th</sup> to 20<sup>th</sup>, the top 20 holdings (which fully account for more than 1/3 of each respective portfolio) in the two funds are essentially the same. This example isn't to dismiss the importance of avoiding unnecessary risk, sustainability-related or otherwise, but it highlights that defining and assessing how ESG risks might impact company performance is not straightforward.

Still, examples of bad behavior from companies are not too difficult to find and companies have certainly been punished. Proponents of ESG investing point to the opioid crisis in the United States—which has killed half a million people in the country over the last two decades—as an example of ESG risks destroying investor capital. Over the past five years, Teva Pharmaceutical shares have lost 80% due in part to its role in the epidemic while Purdue Pharmaceutical, a large private healthcare company, was put into bankruptcy after billions of dollars in related court settlements. Other major players including Johnson & Johnson, McKesson, and Amerisource Bergen are all similarly preparing for large settlements in the future.

However, most other healthcare companies deemed responsible by regulators have shown either limited signs of wear or no signs at all over the past five years (as seen in the chart below). Johnson & Johnson has set aside \$5 billion for potential future settlements, which would be one of the largest medical settlements in history. But the same firm made roughly \$15 billion in profits in 2020 alone. It is unlikely that a company as large and imposing as J&J would be fundamentally damaged from any future action—which seems to be accepted by the firm running ESGU as J&J features prominently in its top holdings.



Koyfin data; July 1, 2021





Returning to the sin stocks, even something as socially taboo and detrimental to public health as smoking, has not resulted in the major companies (Philip Morris and Altria, for example) disappearing. If anything, regulation enacted to curb the health impacts of tobacco has *improved* the profitability of these businesses. And this gets at one of the troubling market realities for any ESG investor: regulation seldom works the way you expect it will.

In like manner, we're seeing increasingly dramatic action after years of slow-building tension play out in the oil industry. In 2013, ExxonMobil was the largest company in the world (larger even than Apple) but shares have gradually declined by 30% since then (though dividends have kept returns positive). That slow bleed was met with sudden action when in May, one quarter of the firm's board of director positions were granted to a small ESG investment firm focused on making the company more sustainable. The firm, Engine 1, owned just 0.02% of Exxon's shares prior to the vote but mounted a successful campaign by courting large pensions and index funds to oust existing board members and begin to focus the company on a "fossil free future." In the same month in the Netherlands, a Dutch court ruled that Royal Dutch Shell will need to speed up its own transition by cutting its CO2 emissions by 45% by 2030. Crucially, the court ruled that Shell was responsible for the emissions of its suppliers as well in hitting this target.

But, as with tobacco, it remains to be seen if regulation or shareholder action leads to their expected or intended outcomes for the ESG investor. Do regulations and corporate action make these companies greener and more profitable? In the tobacco industry, because of the obvious health risks, regulators increasingly limited how a company could advertise and market its products. For smaller fledgling tobacco companies this was almost a death sentence. How could a company possibly convert existing smokers or gain new ones if it was unable to market or brand its products? What did not change immediately was the smoker's appetite for cigarettes. Large, existing tobacco companies could be assured of not facing a new competitor while still having customers craving their products. Over the years, these businesses went from being in a cutthroat market and spending a significant amount of money on advertising to gain or retain market share to operating in a regulated oligopoly.

Likewise, for the emerging and struggling companies in the fossil fuel markets, new regulations and diminishing investor appetite to fund new projects could be devastating. If commercial banks and capital markets continue to shun dirty industries, new wells, mines, or exploration projects are much less viable. But for the existing companies, particularly those with strong market positions and existing reserves, it may be the best opportunity they have had in decades. Like the smoker, our industries are not yet in a position to fully kick the habit of a fossil fuel dependence and with billions in India, China, and elsewhere eager to raise themselves out of poverty into industrializing economies, this demand continues to grow. Despite the justified optimism around alternative energy sources, EVs, and overall energy efficiency, the demand for hydrocarbon energy will not reverse overnight.

So, what does all of this mean for us and you? Well, nothing material yet. We continue to watch the "ESG" trend with interest, curiosity, and some skepticism even while we continuously review the changes in fossil fuel industry and continued advancement of renewable technology. We expect ESG investing will continue to be an increasing trend with investors, regulators, and other stakeholders all pushing for years to come. But these investor actions and political regulations will



undoubtedly have unexpected effects. They may present great opportunities for Canadian energy companies to further supply the energy needs of the planet but may also be a harbinger of future regulatory changes. In the end, our view on the merits of these legal actions and regulations is immaterial. Our job is to predict and, more importantly, react to them. Nothing at Exxon or Royal Dutch Shell has actually changed (yet), but the rapidity and potential severity of the disruption at two of the world's largest fossil fuel companies should cause all investors to sit up and pay attention.