# WEEKLY REPORT DECEMBER 2022

## Private Asset Management Ltd

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

## WHY ESG INVESTORS MAY NOT BE THE BRIGHTEST AND HOW TO PROFIT FROM THEIR DECISIONS (Part 3)

Unlike many financial advisors who continue to pick stocks for clients, I have a great deal of respect for the efficient market hypothesis (EMH). It is not perfect but, like Winston Churchill may have said about democracy, it is better than most of the alternatives. One of the key conclusions of the EMH is that it is difficult to beat the market on the basis that, with so many clever people analysing individual stocks, currencies etc, not to mention insider trading, things are priced correctly. This is common sense but maybe the EMH needs to be tweaked given the massive impact of ESG investing on prices. Today we have so many people apparently adamant that they won't buy oil stocks, tobacco companies or businesses involved in defence that that belief has the effect of making these company's share prices lower and dividends higher than they would otherwise be. Given this reality, it may be that the best way to outperform is to be on the other side of all the transactions involving ESG investors i.e. underweight ESG stocks and overweight the bad stocks. Today, in this final story on ESG, we will examine the anecdotal evidence suggesting that some retail ESG investors don't have the best investing skills and thereby may be exploited by the finance sector. We then look at why some of the fundamental tenets of the ESG religion are flawed.

The fund management industry has a long history of abusing its customers and my view is that many retail ESG investors may be its most recent victims. Whilst the extent of the rort in terms of returns foregone pales against previous local scams like finance company debentures, the unlisted property disaster and CDO misadventures the sheer scale of ESG and the related geopolitical consequences may be unprecedented. To understand why retail ESG investors are attractive to the fund management industry and financial advisors consider the following:

- Firstly, they believe the marketing from fund managers that you can outperform whilst "doing good". As we saw in the previous column and as many independent studies have suggested ESG portfolios frequently only outperform if they stand by a short benchmark. "Doing good" is often problematic as well - ESG evangelists like to describe avoiding oil and defence stocks as achieving "positive outcomes" but unfortunately the unintentional negative consequences of "doing good " can sometimes produce a net result that is "not good". Unfortunately, because financial advisors control the supply of ESG related information including benchmarks available to clients, they are usually oblivious to both the performance shortcomings of their portfolios and the negative consequences of their actions.

- ESG investors invariably pay relatively high fees, mainly to active managers, for the privilege of long-term underperformance. Anecdotal evidence suggests that retail investors have a far higher exposure to active management in the ESG area than ESG constrained institutional investors. This is no doubt due to advice from financial advisors: a recent survey in the UK concluded that nearly three-quarters of financial advisors "agreed that ESG investing was better suited to active funds". Most financial advisers have enthusiastically embraced ESG because it makes their job of selling products easier, conveniently deflects the narrative away from issues like fees and value for money, and it's an important area where they can engage with clients and thereby strengthen relationships.

- Even though ESG portfolio construction is hugely inconsistent ESG investors either don't notice or don't care. For example governance is a key variable yet ESG investors are happy to own companies based in China despite the fact it's well known that these companies' overarching responsibility, ahead of those of shareholders, staff and customers, is to the Ccp. Any Chief Executive who forgets that gets to disappear for a couple of months. It's interesting to speculate why China is rarely the focus of the fund managers and investment advisers that "guide" retail ESG investors – my guess is that because the Chinese financial markets are so lucrative to fund managers they are in no hurry to get offside with the Ccp. Profits always trump ethics in the finance sector, despite all the virtue signalling and the plethora of ethics courses and ESG conferences attended by Chartered Financial Analysts.

We will now look at some of the fundamental flaws in ESG specifically as they relate to the exclusion of oil stocks and how these policies result in "not good" unintended consequences:

- The way the business world works is that firms respond to demand. So if one was looking to eliminate fossil fuels one should divest companies that use fossil fuels rather than companies that produce them. Not owning oil stocks but at the same time owning Mainfreight, Amazon shares, Ford or Boeing is obviously incongruous but ESG compliant portfolios are full of these sorts of anomalies. Incidentally, I have some friends who are classic ESG disciples. They read the Guardian (so are also probably communists), are into Forest and Bird (as am I) and are very anti oil stocks. They ignore their own carbon footprint - they drive lots and frequently fly overseas long distance. As such they represent "demand" for oil but at the same time their actions are constraining the Western based oil "supply". Climate change is so well entrenched that no matter what capital is supplied to fossil fuel companies the world is inexorably moving to less harmful substitutes but the capital drought facing western oil companies has had the effect of reducing production capacity and has materially contributed to inflation.

- Secondly, if we acknowledge there is demand for fossil fuels and given that the ESG community has reduced the capital available for the western worlds' development of these resources and increased the oil sector's cost of capital then the unintended consequence of these actions will be to enhance the positions of those oil companies not constrained by ESG investors, by increasing prices and improving the latter's market share. The big players here include Saudi Arabia and Russia. By improving the position of bad actors we are effectively financing the regimes of people like Mr Putin and Sheik whatever his name is. Furthermore increasing our reliance on these sort of people allows them, as the Economist argued last week, to use energy as a weapon: "In August Mr Putin turned off the taps on a big pipeline to Europe. Fuel prices surged". The paper then goes on to argue that "the death toll from Mr Putin's energy weapon could exceed the number of soldiers who have died so far in combat."

- The ESG crowd argue that one should divest oil stocks because their assets will be "stranded" ie worthless. That's naively simplistic – everyone knows that the world is moving toward a future with lower oil consumption so it's obviously ridiculous to think that the stock market hasn't already priced this in. In fact a recent report by Longview Economics highlighted the fact that energy is one of the cheapest sectors of the UK stock market - trading at a price earnings ratio of just 5.1x. In other words its market value is represented by just 5 years of the current level of profitability.

Another big impact of an ESG filter is to exclude defence stocks – thereby raising the sector's cost of capital - the price of its equity and the interest rates it has to pay on its debts. The unintended consequence of this strategy is that it reduces the Western world's ability to defend itself e.g. the US defence stocks have a lower comparative advantage relative to those in Russia and China than they would have otherwise. The Ukraine war has also served to illustrate the obvious folly of not investing in defence when you have bad actors in charge of countries close nearby.

So how might one exploit the non ESG stock discount and at the same time, in some small way, offset the negative impacts of ESG's unintended consequences? Unfortunately all the major ETF providers are too scared to offer a sin stock ETF but one closed-end fund that seems to be ESG agnostic is the NZ listed, UK based, closed end fund, City of London. It's 10 largest holdings include two tobacco companies, two oil companies and the UK's largest defence contractor. Over the last 23 years it has performed as well as the world stock market which is a pretty good effort. Additionally ESG agnostic investors can buy oil ETFs or invest directly in the large listed US defence contractors like Lockheed Martin.

**Disclosure – Brent Sheather owns shares in City of London, an oil stock ETF and various US defence contractors.**

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request.