Why no one will talk about ESG in 10 years' time

According to Katherine Davidson, portfolio manager and sustainability specialist at Schroders, there need not be a trade-off between maintaining high environmental, social and governance (ESG) standards and gaining profitable returns. In fact, good "corporate karma" implies that companies that look after the environment and their wider stakeholders will be rewarded with gainful shareholder returns.

Katherine Davidson, portfolio manager and sustainability specialist at Schroders. | Source: Supplied.

Davidson, who recently shared her insights on how sustainable investment has shifted from "niche to norm" at the 2021 Allan Gray Investment Summit, says the acronym 'ESG' may someday be rendered obsolete, given the rate at which sustainability considerations are becoming embedded in the way all managers invest.

"Sustainable investing is underpinned by a strong financial imperative"

Davidson illustrated the concept of "corporate karma" by way of a practical example: "Companies that maximise short-term earnings by underinvesting in staff benefits, occupational health and safety and diversity and training will experience higher employee turnover and struggle to attract and retain real talent. In the long-term, this is likely to prove expensive.

"There will likely be a higher possibility of strikes and walk-outs which will have a knock-on effect on the company's reputation with other stakeholders as the world is becoming a place where people care about the values of the companies they support."

Academic research suggests that companies that take a stakeholder-centric approach to doing better business ultimately produce superior operating performance over time. Davidson put forward the example of Kenyan telecommunications company Safaricom, which runs the M-Pesa money transfer platform.

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According to KPMG, the company has generated over ten times its profit value in positive externalities and Schroders' analysis finds strong relationships across its stakeholders. Since 2013, it has quadrupled its value in US dollar terms - an encouraging demonstration of the business case for ESG.

She explained that three prominent trends have positioned sustainability as a key consideration in the investment landscape, the first of which is the regulatory push (led primarily by Europe) around ESG compliance.

"The second is the increase in client demand, which can be corroborated by the measurable upsurge in questionnaires containing content on how ESG impacts investment decisions. Finally, research by Schroders shows that an upward trend in ESG vs non-ESG equity flows makes a solid business case for the fact that sustainable investing is underpinned by a strong financial imperative," Davidson explained.

Qualitative approach best when assessing ESG characteristics

Davidson also pointed out that in a recent survey, 62% of Schroders' European and South African institutional clients indicated that ESG factors were becoming significantly more important when asked the question: "how has the Covid-19 crisis impacted your view on the role of sustainable investing within your organisation?"

However, Davidson cautioned against relying on rating agencies and third-party assessments to identify companies with good ESG characteristics. For example, rating agencies are divided where US electric vehicle and clean energy company Tesla is concerned.

"This is because everyone has a different perspective and interpretation of what ESG means in a practical sense. There is too much complexity and subjectivity involved in determining the investment value of a company through the lens of ESG imperatives," she explained.

Importance of ESG grows

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Davidson suggests a qualitative approach. Quoting Einstein's famous line - "not everything that counts can be counted and not everything that can be counted, counts" - she argued that investment firms need to perform deep analysis of companies, engage in debates and examine corporate culture in a way that does not rely solely on data but also assesses the relationship between a company and its stakeholders.

"We strongly believe that 'impact' will become the third dimension of investment decisions and equally important to the already-familiar risk and reward dimensions. Our research continues to show that consistent business outperformance is possible without causing harm to society or the environment," she concluded.