Slaying the three ESG dragons
Inconsistency, hypocrisy and the beast of unintended consequences

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Sceptical observers believe the ESG movement has trouble defending itself against three fire-breathing accusations

- **Inconsistency**: “There are too many grey areas and conflicts of logic”
- **Hypocrisy**: “Who are you to talk anyway?”
- **Unintended consequence**: “Your actions make things worse!”

Source: Deutsche Asset Management (UK), October 2017
The accusation of inconsistency is still the most common criticism of ESG – and has three main angles of attack

- **Vertical inconsistencies**
  (No one agrees on where to stop)

- **Temporal inconsistencies**
  (Societal norms change over time)

- **Horizontal inconsistencies**
  (The difficulty of ranking good and bad)

Source: Deutsche Asset Management (UK), October 2017
Supposed horizontal inconsistencies come from the fact that definitions of good and bad can differ between investors.
Horizontal inconsistencies can arise when analysing a company, business line, country – or even financial statements.

Revenues?  |  Profits?  |  Cashflow?
Vertical inconsistencies can come from long supply chains and the fact that globalization has connected everything.

Where do you stop?

Coal miner

- accountancy firm
- software provider
- commodities trader
- rubber producer
- tyre manufacturer
- truck maker
- shipping line
- ship builder
- steel manufacturer
- creditor bank
- majority shareholder
- consultancy

For illustrative purposes only
Temporal inconsistencies are due to changing societal norms – what is acceptable and unacceptable differs with time.
The charge of hypocrisy is simple but powerful because it extends to every corner of the investment landscape.
Institutional investors are especially open to the charge of hypocrisy because they want to take the lead on ESG issues.
Meanwhile the beast of unintended consequences can be hard to spot or may not make an appearance for years.

Electric cars are a good idea...

...Ooops!

Some cobalt in cathodes is possibly dug out by child labourers in the DRC and profits could benefit warlords.

Lithium batteries profits are likely supporting some companies with governance issues.

Fall in supply of coal in developed world leads to higher demand for dirtier coal from countries such as Indonesia.

Source: Deutsche Asset Management (UK), October 2017
In addition there is the philosophical issue of prioritising the future over the present – a big topic for wealth funds.

Corporate long-termism is a good idea...

...Ooops!

A lack of short-term accountability can lead to profligacy, waste and over-investment.

Companies can suffer lower asset-turn and reduced returns on equity.

Countries can suffer low economic growth, falling wages, unemployment and deflation.

Long-run focus causes short-term instability, which precludes objective.
To win over sceptics and ensure that ESG is imbedded into investing forever, we need to slay these dragons!

- Inconsistency
- Hypocrisy
- Unintended consequence
The best weapon against horizontal inconsistency is to admit to grey areas, not proselytize, and invest heavily in research.
The problem of horizontal inconsistency can be solved via the process aggregation and ranking – and ultimately trading?

- Amcor
- Uber
- Pfizer
- Samsung
- Shell

A. True leaders
B. Runner ups
C. Upper midfield
D. Lower midfield
E. Slow starters
F. True laggards

ESG Engine

ESG credit marketplace
The whole global supply chain as well as each individual company can be put through an ESG engine and ranked.

- Accountancy firm
- Software provider
- Commodities trader
- Rubber producer
- Tyre manufacturer
- Truck maker
- Coal miner
- Shipping line
- Ship builder
- Steel manufacturer
- Creditor bank
- Majority shareholder
- Consultancy

A: True leaders
B: Runner ups
C: Upper midfield
D: Lower midfield
E: Slow starters
F: True laggards
Temporal inconsistencies are hard to slay – you can’t forecast the future and it rarely pays to front run societal norms

Investor response

- Leave politics to governments
- Obey current rules and regulations
- Invest in ESG related research
- Be flexible and alert to change
- Respect different views

Source: Deutsche Asset Management (UK), October 2017
To avoid the charge of hypocrisy, investors should become best practice when it comes to ESG – do as I say won’t cut it

ESG targets for management

Complete transparency

Stakeholder engagement

Active ownership

Align with UN Sustainable Development Goals

Institutional best practice

External affiliations and accreditations

Mandatory training

Impact investing

World class research and analysis

Deutsche Asset Management
By definition unintended consequences are impossible to stop and trying to prevent them will have unintended consequences.
Conclusion: the three dragons can be slain with a mix of research, analysis, humility and best practice behaviour

<table>
<thead>
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<th>Dragon</th>
<th>Weapon</th>
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<tbody>
<tr>
<td>Inconsistency</td>
<td>“Your logic is weak and confused...”</td>
</tr>
<tr>
<td>Hypocrisy</td>
<td>“Who are you to talk anyway?”</td>
</tr>
<tr>
<td>Unintended consequence</td>
<td>“Your do-gooding makes things worse!”</td>
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Source: Deutsche Asset Management (UK), October 2017
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