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ESG and the War in Ukraine: Part 2

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In Part 1 of this series, we articulated our argument for why definitions are so important in the world of ESG, and why labels such as "ESG-friendly" or "socially desirable" are rarely precise enough for our liking. We also discussed why it's important as ESG analysts to delve into what sociologist Robert K. Merton called the manifest and latent function of controversial companies. The manifest function of these companies is to provide the goods and services that is their primary raison d'etre, but their products often have latent functions that are more subtle and hence require more analysis.

One vigorous debate among investors in controversial sectors is about divestment. We define divestment as the wholesale exclusion of entire industries for non-financial reasons. We distinguish this from (a) the wholesale exclusion of entire industries for primarily financial reasons, and (b) the decision to sell or not purchase a security on the basis that one is not compensated for ESG risks, broadly defined. In each of those latter cases, the drivers of the decision to exclude, sell or not purchase a security is driven by primarily financial considerations.

Divestment has long been linked with Socially Responsible Investing, with certain investors refusing to consider investments in sectors such as tobacco, alcohol and gambling. The divestment debate has picked up steam recently as investors question whether they can justify owning large carbon emitters such as utilities and fossil fuel producers.

Epoch's position has been to eschew divestment but instead to consider companies on a case-by-case basis. We have adopted this position for several general reasons, and some specific to various industries, which we will cover in the next post in this series. At a general level, however, we have avoided divestment because:

1. Blanket exclusions constrain our investment universe, immediately demanding a trade-off in our fiduciary duty to clients. Individual clients may request constraints in line with their specific situation, but we do not feel it appropriate to extend those across the firm.

2. Many of the companies targeted by divestment movements have a manifest and latent social function. We prefer to acknowledge their social benefits while highlighting social costs and grappling fully with ethical complexity as owners. To cite an obvious recent example, various constituencies are now calling for U.S. shale producers to increase their output to counter Russian influence on the energy markets. Those who opted for divestment must wrestle with the fact that these companies have become important swing producers in the oil market and now contribute to global energy security more than ever.

3. By selling a security, we lose our seat at the table. With diminished direct influence with companies, we have fewer levers to create change that benefits our clients in the short or medium term.

4. Finally, divesting transfers ownership to other investors who may be less concerned about ethics or more opaque in their ESG practices. This is particularly visible when Western fossil fuel producers sell their assets to private investors or state-owned companies from jurisdictions with fewer concerns about climate change.

Generally, we prefer engagement with companies where we believe there is sufficient ethical complexity to warrant a deeper dive. Our engagements seek to evaluate if companies are taking their responsibilities seriously. We aim to use qualitative and quantitative information to decide how companies might fare in different regulatory scenarios.

This is not to suggest that divestment is without merits. We believe that the ability to sell companies which do not thoughtfully explain their position on various ESG issues is essential to what we do as active managers. However, that does not require a blanket exclusion on entire sectors. Furthermore, when companies do not respond to engagement, exiting is often the right option. A wave of exits can be a powerful signal to companies that change is required. Most large public companies do not want to be seen as having a shareholder roster populated only by those who neglect all ESG issues. Finally, it's true that in extreme situations, high levels of divestment can starve a sector of capital. It is debatable, however, if that is always for the best. Recent high oil and natural gas prices are primarily the result of underinvestment after a long period of low prices, demand destruction from COVID-19 and investor frustration about poor capital allocation. We should not add fuzzy ESG thinking into the mix.

When, then, might divestment make sense to us? Simply put, we would consider a divestment policy if an industry's business model was so egregious for us to decide that any manifest and latent social functions were outweighed by the industry's harm. For example, if an industry relied on a high amount of modern slave labor in order to be profitable, we would not shy away from excluding it.

It is also worth mentioning that, despite our preference for engagements, some clients simply prefer a blanket exclusion. Perhaps they find certain industries too ethically compromised or do not want the reputational risk of being associated with such companies. For such clients, we are happy to implement the necessary exclusions without implementing a firmwide divestment policy.

We have mostly spoken in the abstract about controversial industries. In Part 3 of this series, we will discuss three sectors – Energy, Defense and Technology – where the war in Ukraine has demonstrated the limitations of some ESG definitions.