Cartica Management, LLC
Letter from the CEO

ESG Naysayers: Cartica's Response

It has become fashionable to question the utility of ESG investing. And why not? The last few years has seen a flood of new active and index funds using the words *ESG*, *Sustainability,* or *Impact* in their names. There have been titillating headlines about "greenwashing." For example, criticisms around Deutsche Bank's DWS investment arm's ESG work appear to have taken down the bank's stock price. And it is well known the myriad ESG ratings in the marketplace are higgeldy piggeldy: they all rate different "material" items and they rate the same items differently.

As an investor who works with portfolio companies by engaging on ESG issues, we at Cartica need to pay attention to the naysayers to see what we can learn. It seems that the arguments fall into four categories, and I will address each one in more depth below:

1. **Cost of capital.** If the cost of capital is *lower* for better ESG firms (i.e., the P/Es are higher), shouldn't you invest in the *worse but cheaper, so-called "left behind"* stocks?
2. **Ratings mess.** Since the ratings are so unreliable, isn't investing in an ESG fund pretty much the same as investing in any other fund?
3. **Greenwashing.** Given that the field is so nascent and the assessments so subjective, isn't it impossible to distinguish between "greenwashing" and sincere efforts to improve corporate practices?
4. **It is not investors' role.** Shouldn't investors just invest for profit? Also, isn't the belief that investors can sway corporate practices with their money and their proxy-voting voice a "dangerous distraction" since only government policy can solve big social and environmental issues?

1. Why not invest in companies with *higher* cost of capital (likely lower P/Es)? Aren't they cheaper?

I find the argument on cost of capital the most interesting. Robust research over the past 20+ years has shown that companies that improve their *governance* become more valuable, i.e., their stock price rises.[i] In the last ten years or so studies that focus on *environmental* factors delivered the same conclusions.[ii] And in just the last five years, research on *social* factors has also shown positive results so far.[iii] [iv]

A decade ago, renewable companies had about the same cost of capital as fossil fuel firms, usually between 8% and 10%. But now, according to a Goldman Sachs study, offshore oil faces a cost of capital around 22% and for LNG firms it's about 12%. The renewable average, however, is under 5%.[v]

The naysayers are right to ask: "If companies with good ESG have lower cost of capital/likely higher stock prices, then shouldn't investors eschew these in favor of companies whose similar stream of cash flows can be bought more cheaply?"

To those skeptics wanting to **buy the "left behind" non-ESG stocks**, I have three answers:

We see an opportunity to create value

We at Cartica agree that buying stocks that are currently not perfect on ESG is a great strategy. For example, one company with a troublesome governance structure restructured its share classes last year; it was rewarded with a jump in stock price of 33% in 9 days in January. Then the stock continued to climb another 87% for the rest of 2021. Cartica looks for companies where we can foresee improvement in ESG and other business factors that can lower the cost of capital.

Companies are never "done" improving on ESG

It is usually the most alert management teams that seek to improve on ESG. We find these are exactly the companies that *continue* to improve their practices and disclose them. And they are likely to see *further* decreases in the cost of capital. Nothing is static. We have also found that getting started on implementing better ESG practices, policies, and disclosures is often the hardest part. Once companies begin to disclose data, hire staff to oversee key processes, start reporting to the board, etc., it is often easier to continue to improve after overcoming the initial learning curve. Research has shown that investing in ESG "improvers" – firms showing improvement in their ESG practices rather than already leading in their industry – can provide greater potential for alpha in the long-term.[vi]

Active management helps to identify companies with good practices and bad disclosures

One needs to have great fundamental analysis skills to invest in the "left behind" companies with allegedly bad ESG practices. We at Cartica will analyze these companies for their potential to improve. But Cartica has been deeply engaging with a concentrated portfolio of companies for the last 12 years. In our view, most investment managers with larger portfolios and shorter experience are not set up to do this and are likely to look at them as "value" opportunities. We at Cartica try to make sure the company is open to change, is eager to improve, and has good fundamental prospects.

2. Doesn't the ratings confusion show that there is no extra value created from ESG funds?

Now onto the ratings mess. It is well known that there are hundreds of ESG ratings services and maybe a dozen that count. The commercial ratings from different providers have also been shown to have little correlation to each other. E.g., one service may give a company a high "AA" mark for Social practices and another may give it a disgraceful 3 out of 10, based on different models for materiality and risk, as well as different means of data collection, quality assessment, etc.

So, when buying a passive ESG index fund, the investor is at the mercy of the ratings system chosen by the indexer. Do many of the underlying companies in the index fail to meet the standards of a reasonable person? Most likely, yes. The indexes tend to overweight companies that *disclose* information regardless of how robust their underlying practices are. I suspect that companies in the Advanced Economies understand how to game the ratings providers and may overstate their ESG accomplishments or simply disclose everything they can.

In the Emerging Markets we often find the opposite. In Cartica's markets, we have observed that many companies are likely to have *better* practices than what they report. And since most of the ratings agencies are scraping the internet for what is *disclosed*, the EM companies are more frequently under-rated than over-rated on their ESG, in our experience. This is especially true of companies that are younger or newer to the public markets.

But there is an elephant-in-the-room in terms of widely available funds claiming to be ESG. That is that 60% of all retail money goes into funds that are based on ratings from MSCI.[vii] There are four problems with this:

I. MSCI seeks only to identify the risks and opportunities that affect a company in the areas of E, S, and G. It is a one-way valve. They do not look at the effect a company has on the environment or the community. So, when they look at water stress, for example, they look only to see if the company has sufficient water, not if the company is leaving the community enough clean water for its needs.[viii]

II. The single-minded focus on the effect on the company leads to some strange ratings decisions from the viewpoint of the everyday investor. For example, MSCI eliminated carbon emissions as a consideration for McDonald's because they believed emissions did not threaten the company or provide it a business opportunity.[ix] So, despite McDonald's producing more greenhouse gas emissions than Portugal and experiencing rising emissions, MSCI eliminated the category for McDonald's and then gave it an upgrade. They did give McD's environmental points for putting recycle bins near stores in France and the UK … where they are mandatory. (Another complaint is that MSCI seems to give companies points for the most rudimentary of good business practices, like a data company hiring a cyber-security expert.)

III. The many funds that use MSCI ratings for their products apparently rarely lay out the entire methodology for the investors (I have not read every prospectus.) The BlackRock iShares ESG Aware MSCI USA fund touts this as a way to invest in "US companies that have positive [ESG] characteristics".[x] The same formulation is used for their EM product. But MSCI ratings do not measure or rate "positive characteristics" in the way most retail investors understand this. MSCI bases ratings on practices they deem favorable to the company regardless of damage they might inflict on the planet's environment or on society. MSCI does not even claim to look at the externalities that most serious players in the ESG community are grappling with.[xi]

IV. MSCI uses the symbols of the financial ratings firms like S&P, Moody's and Fitch. Their ratings go from CCC to AAA. But whereas the debt raters use highly similar methodologies and their ratings do not diverge greatly from one another, that is not true of the ESG raters. And BBB does not signify the equivalent of "investment grade" in the MSCI world.[xii] While this may be a minor point, it is an irritant to some serious ESG practitioners that MSCI seeks to appear so definitive when their ratings are in direct conflict with other ESG raters.

Recognizing that the ratings services have a lot of work to do as the sector matures, the majority of active ESG investors use ratings as one source of information, but they focus on assessing the material ESG factors themselves through their own investigative work, as Cartica does. I do believe that investors are better off with actively managed ESG funds than passive funds that rely on a third-party rating. This is especially true in the EMs where even standard, non-ESG index funds almost never beat even the average active manager.

3. Isn't it impossible to avoid greenwashing?

Greenwashing is growing along with the ESG market. Many companies and asset managers see an opportunity to attract "green" investment by tweaking their marketing strategies, instead of their core business practices. Institutional allocators and retail investors do need to do the work to understand the actual practices of a fund manager to ensure they are not investing in a strategy that merely claims to be "sustainable," or to support diversity, or to invest in good governance.

There are number of steps that investors can take to spot greenwashing at companies and funds. This can include requesting companies to produce baseline sustainability data as well as goals for improvement and progress toward those goals, requesting information about who leads sustainability at the company and on the Board, and requesting that reports be produced using one of the many sustainability frameworks (TCFD, GRI, etc.)

Increasingly, as the industry matures, investors have help. In addition to the ratings providers, there is a growing number of watchdogs who are paying attention to what companies and asset managers do, not just what they say. For example, nonprofit As You Sow releases a list of 3,000 retail investment products scored on varied social responsibility metrics. Climate Action 100+ maintains a list of the largest GHG-emitting companies and organizes investors for action. The 30 Percent Coalition reports on companies that don't have women on their boards, and the Human Rights Campaign releases a list of best companies for LGBTQ employees.

We will also see progress from regulators in many jurisdictions, led by Europe, in the next few years that will aid in comparing investment products' sustainability credentials. We will also see stock exchanges in many countries, including in Emerging Markets, require increased disclosure from companies on ESG factors using a common template. This will help to continue to build the data and reporting regime that investors need to appropriately evaluate companies on greenwashing.

4. How is this our job?

It is not the role of companies or investors to save the world, say some. In a capitalist system, they say, investors should allocate capital solely based on expected profit. Considering externalities like a potential investee's emission levels is not the business of an investor. Second, they assert, it is the role of government and philanthropy, not companies, to address environmental and social issues. We disagree on both points.

Companies see themselves as responsible to stakeholders and shareholders

For fifty years the Freidman doctrine held sway (the headline of Freidman's 1970's opinion piece encapsulated the doctrine: "The Social Responsibility of Business Is to Increase Its Profits"). Today, that philosophy is being reevaluated. In the Emerging Markets the old concept of "corporate social responsibility" (CSR) took hold quite widely about 20 years ago. At least two countries, India and South Africa, have codified CSR; both mandate that a percent of profits must be given for the social good. And the practice is widely observed since many EM companies are aware they operate in countries with high poverty rates and feel obliged to help.

At the same time, the ideas of "conscious capitalism" and "responsible investing" have crept into the thinking of many investors and corporate executives around the globe. In a McKinsey survey conducted before the global pandemic, nearly 60% of corporate respondents said that stakeholder engagement (with communities, customers, and other external actors) was one of their top three CEO priorities, and 50% said that the topic was a top priority of the Board.[xiii]

One of the primary counterpoints to the "profit-only" school is that good ESG evaluation helps manage risk. What are the risks any analyst must incorporate in determining the profitability of an investment?

Large tomes have been written on the subject (see Peter Bernstein's 1998 "Against the Gods" for one.) But sloppy practices in ESG or corporate culture (ESGC, we say) pose risk to the future cash flow of the company. Bad press on maltreatment of workers can hurt recruitment, turnover, and customer loyalty. Substandard environmental practices can cost a company fines and new customers. Asbestos lawsuits famously drove many dozens of companies into bankruptcy. Flaws in a company's culture can prevent it from seizing opportunities like the famous case of IBM not knowing what to do with the personal computer after they invented it.

Because of this perception of risk, and specifically ESG-related risk, C-suite respondents in a 2020 survey of large corporations said that they would be willing to pay a 10% premium to acquire a company with a positive ESG record, versus one with a negative record.[xiv] They are recognizing that mitigating ESG risks can translate into real value.

The private sector plays a critical role in solving problems and can do so profitably.
Philanthropy is too small and government is too slow to solve some of the world's greatest problems without the participation and support of the private sector. There appears to be a mounting aspiration for collective action as illustrated by the "all-hands-on-deck" response to the climate crisis. The growing consensus is that this issue must be addressed on every level from global institutions to country governments to local authorities to corporations to households to individuals.

Some naysayers believe that government intervention is the <u>only</u> way to combat climate change via policy and regulation. One naysayer hinges his arguments on one thing: the price of carbon. He says this is the remit of the government and not individual corporations. Interestingly, in the last year the market, not government, has made his wish come true.

At COP 26, investors representing $130 trillion of assets pledged to invest their assets to ameliorate climate change. Most of the financiers at COP 26 would say that there is a huge scope for improvement on all elements of ESG and combatting climate change, regardless of the carbon price. It is clear these financial leaders see themselves as a piece in the climate puzzle; they do not see their remit to lower emissions as a "dangerous distraction" to use the phrase of one naysayer.

We do not believe that most companies would commit themselves to action if they did not believe that they could reduce risks and increase profits because of it. And it will be immeasurably harder for government to make change in most countries without the support of the private sector, which is extremely influential in policymaking (and campaign fundraising).

And for that diminishing group of investors and companies that think they can ignore ESGC considerations because they are a passing fancy – they should ask themselves this question: Do they want their peers who are broadening their focus on ESG externalities, risks, and the opportunities of innovation to surpass them while they are busy defending the status quo?

[i] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=593423.
[ii] https://www.mckinsey.com/business-functions/sustainability/our-insights/sustainability-blog/how-the-e-in-esg-creates-business-value
[iii] https://corpgov.law.harvard.edu/2020/06/28/time-to-rethink-the-s-in-esg/
[iv] https://hbr.org/2016/03/28-years-of-stock-market-data-shows-a-link-between-employee-satisfaction-and-long-term-

value
[v] https://www.bloomberg.com/news/articles/2021-11-09/cost-of-capital-widens-for-fossil-fuel- producers-green-insight?sref=CDQwBb8t
[vi] https://rcm.rockco.com/insights_item/esg-improvers-an-alpha-enhancing-factor/
[vii] https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/
[viii] https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/
[ix] https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/
[x] https://www.blackrock.com/us/individual/products/286007/ishares-esg-aware-msci-usa-etf
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[xiii] https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the- pivotal-factors-for-effective-external-engagement
[xiv] https://www.mckinsey.com/business-functions/sustainability/our-insights/the-esg-premium-new-perspectives-on-value-and-performance